308 Hot Issues with Shareholders

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Carol Bowie

Carol Bowie is director of governance research for the Investor Responsibility Research Center (IRRC), in Washington, DC, overseeing the compilation and analysis of proxy data from more than 9,000 U.S. and global companies annually. IRRC is the only independent, impartial U.S. organization providing research and proxy voting guidance to institutional investors.

Prior to joining IRRC, Ms. Bowie was director of publications and research for Executive Compensation Advisory Services and long-time managing editor of the executive compensation reports newsletter, reporting on trends and developments in executive pay at public companies.

Ms. Bowie is a frequent speaker on a range of governance issues. Her articles have been published in several journals, including *Mergers & Acquisitions* and *Directors' Monthly*. Ms. Bowie is quoted regularly in publications such as the *Wall Street Journal*, *Business Week*, *The New York Times*, and *USA Today*, and she has provided commentary on CNN, CNBC, CNET, MSNBC, and public television and radio.

She received a degree, cum laude, from the University of Maryland.

Patrick S. McGurn

Patrick S. McGurn is executive vice president and special counsel at Institutional Shareholder Services (ISS) in Rockville, MD. ISS is the world's leading provider of proxy voting services and corporate governance research. ISS serves more than 1,300 institutional investor clients. Founded in 1985, ISS recommends votes on ballot issues for more than 33,000 shareholder meetings across 115 markets around the globe. ISS's Corporate Governance Quotient is the global, industry-standard benchmark for ranking governance practices at more than 7,500 public companies.

Prior to joining ISS, Mr. McGurn was director of the corporate governance service at the Investor Responsibility Research Center (IRRC), a not-for-profit firm that provides governance research to investors. He also served as a private attorney, a congressional staff member, and a department head at the Republican National Committee.

He is a member of the bar in California, the District of Columbia, Maryland, and the U.S. Virgin Islands. Mr. McGurn serves on the advisory board of the National Association of Corporate Directors (NACD) and was a member of the NACD's 2001 blue ribbon commission on board evaluations.

He is a graduate of Duke University and the Georgetown University Law Center.

Barbara Wagner

Barbara Wagner is chief compliance officer, associate general counsel and assistant secretary of Chiquita Brands International, Inc. in Cincinnati, Ohio. Appointed CCO in February 2005, she is responsible for the day-to-day operation of the company's compliance and ethics program, including communication, training, risk assessment, monitoring, and measurement. She is also involved in corporate, securities, finance, Sarbanes-Oxley compliance, and corporate governance.

Prior to joining Chiquita, Ms. Wagner worked at Frost & Jacobs (now Frost Brown Todd) in Cincinnati, and at Shearman & Sterling and Skadden, Arps, Slate, Meagher & Flom in New York City, where she was involved in a variety of corporate and securities matters.

She is an adjunct professor at the University of Cincinnati Law School, and involved in several activities for high school and college students interested in careers in law. She also recently completed a three-year term as a member of the board of governors of the Association of Yale Alumni, is a past president of the Cincinnati Yale Club and has served for over 15 years as director of the alumni schools committee of the Cincinnati Yale Club.

Ms. Wagner received her B.A. from Yale University, an M.S.B.A. from Boston University, and her J.D. from Columbia Law School.

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HOT ISSUES WITH SHAREHOLDERS

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Materials

- SEC's 2005 No-action Decisions Help Determine Course of Proxy Season
- Labor Funds' Negotiations Spawn Withdrawals in 2005

SEC's 2005 No-action Decisions Help Determine Course of Proxy Season

Several SEC decisions that allowed companies to avoid including certain shareholder proposals in their proxy statements helped shaped the 2005 proxy season, especially with regard to controversial shareholder campaigns related to director elections and stock option expensing.

Although, the portion of proposals that the SEC allowed to be omitted remained steady from last year, the types of resolutions ruled out varied. Out of the 786 governance proposals that IRRC is tracking so far in 2005, the SEC has ruled that 116, or about 15 percent could be omitted from proxy statements. In 2004, IRRC tracked 847 governance proposals, of which 125 or an identical 15 percent, were allowed to be excluded.

This year, the commission permitted companies to omit proposals giving shareholders the right to nominate board members, and ruled that some of the more standard proposals could be excluded because companies already had substantially implemented them or were required to implement them in the near future. The SEC also decided that a high profile binding proposal calling for an independent board chair was beyond the board's power to implement.

Death knell for proxy access?

The commission issued its first significant ruling in December when it allowed Walt Disney to omit a resolution submitted by the American Federation of State, County and Municipal Employees (AFSCME) seeking the right for shareholders to nominate board members. In February, Halliburton, Eastman Kodak and American International Group (AIG) also received SEC permission to omit similar proposals submitted by AFSCME, as did Verizon Communications and Qwest Communications. "Given the passage of time since the proposal of [the proxy access] rule…the security holder nomination procedure in [the proposed rule] is no longer necessary or appropriate," Corporation Finance Division Director Alan Beller said in his letter to Halliburton. Beller's letter stated that the Houston-based firm could omit the proposal under rule 14a-8(i-8), which allows shareholder proposals relating to the election of directors to be excluded from proxy statements.

On February 25, AFSCME filed suit against AIG in U.S. District Court, seeking to require the Delaware-incorporated firm to include the union fund's proposal, which was binding, in the company's proxy materials. The proposal would have amended the company's bylaws to allow shareholders future access to AIG's proxy materials to nominate individuals to the company's board of directors. The case is still on appeal in the second circuit, and the company's meeting was postponed until later this summer.

The SEC said all of these proxy access proposals could be omitted from the proxy statements because they dealt with director elections in violation of 14a-8(i-8). Shareholder activists saw these rulings as the death knell for the proxy access proposal that the commission had first proposed in July 2003. That proposal, proxy access Rule

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14a-11, would have allowed shareholder groups holding more than 5 percent of a company's equity for more than two years to nominate a specified number of candidates who are free of ties to both the company and those proposing their nomination.

Proxy access out, but majority votes allowed in

After proxy access proposals were ruled out and the SEC appeared to be stalled on its own proxy access plan, shareholders shifted their attention to alternative proposals aimed at increasing their influence in board elections. These proposals ask companies to change their charter or bylaws to require that directors be elected by a majority vote. In February, the SEC declined to grant Citigroup no-action relief from a request by the United Brotherhood of Carpenters & Joiners (Carpenters) fund to include a 'majority vote' resolution in its proxy statement, thereby paving the way for dozens of others. So far this proxy season, various union pension funds, with the Carpenters leading the way, have submitted 86 of these types of proposals and they are drawing high levels of shareholder support.

May omit 'already implemented' proposals

Quite a few companies were given SEC permission to omit shareholder proposals after arguing that they already had implemented the provisions in the proposals. Out of the 116 governance proposals that the SEC said could be omitted so far in 2005, 25 were left out of proxy statements because the SEC decided that under Rule 14a-8 (i-10), they were "moot by being substantially implemented by the company." Ten of the 25 proposals omitted asked companies either to eliminate their poison pills or subject them to shareholder votes. In most of those cases, the SEC agreed with the companies' arguments that the requests in the proposals had already been met because their boards had adopted a policy that once a pill was approved by the board, it had to be subject to shareholder approval during a certain time frame. Shareholder activist John Chevedden, the proponent of about half of the omitted pill proposals, said the time frame for shareholder approval was a factor that the SEC did not consider in its decision. While the shareholder proposal called for a shareholder vote four months after a board's approval of a pill, many of the companies' pill policies said the vote could take place within a longer time frame. Chevedden asked the SEC to reconsider its decision in a few cases, but the commission stood by its original ruling.

In addition to deciding that several of Chevedden's pill proposals could be omitted, based on i-10, the SEC also ruled that a few of his classified board proposals also could be excluded under the same rule. The commission allowed the companies to omit the proposals, which asked the companies' boards to take the necessary steps to de-stagger their boards, because the companies said they planned to have shareholders vote on management proposals to declassify the boards. "The SEC forces shareholders to be absolutely correct on micro issues yet companies can be off-base on macro issues," Chevedden said referring to the SEC's i-10 decisions.

In an interesting related case, last year Weyerhaeuser was given SEC permission to omit a classified board proposal under i-10 because the company said it was putting a management proposal to de-stagger the board up for a shareholder vote at its next annual meeting. The company did include such a management proposal in its proxy statement, but recommended that shareholders vote against it. The proposal, which required a supermajority vote of 66.7 percent to pass, was not approved by shareholders. This year, the company did not appeal to the SEC to have a classified board proposal submitted by Calpers omitted. Preliminary voting results indicate that the proposal received 74 percent of the votes cast. This is not the first time a shareholder proposal on this issue has drawn such strong support at the company—classified board shareholder proposals passed in three of the past five years.

Future expensing requirement is basis of omissions

Eight proposals asking companies to begin expensing their options also were omitted under i-10. The companies argued that, under Statement 123R issued by the Financial Accounting Standards Board on Dec. 16, 2004, they would be required, as of the first interim or annual reporting period that begins after June 15, 2005, to recognize options as expenses in their financial statements. "Statement 123R accomplished the objective that the proposal seeks to implement as it will require the company to expense the cost of options in its quarterly and annual income statements—not just the 'annual' income statements as requested by the proposal," lawyers for Yahoo argued to the SEC.

Interestingly, after the SEC allowed the omission of these proposals, it announced April 14 that it had amended the implementation timetable for FASB's requirement that companies expense stock options beginning June 15, by making the rule effective for the first *annual* reports issued for fiscal years ending after that date. The new schedule gives most issuers an additional six months to comply. Some shareholder activist worried that option expensing may never become a requirement because President Bush's pick to be the new SEC Chairman, Congressman Christopher Cox (R-Calif.), has expressed opposition to such a mandate. Cox represents an area populated by tech firms, which are known for granting options liberally. In February, he cosponsored H.R. 913, the Broad-Based Stock Option Plan Transparency Act, which would avert mandatory expensing and would instead direct the SEC to require enhanced disclosures of employee stock options, and require a study on the economic impact of broad-based employee stock option plans. The bill is currently in the House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises. In the last Congress, Cox also cosponsored H.R. 1372, which was virtually identical to H.R. 913. That bill languished in committee. In Senate hearings related to his confirmation as the new SEC Chairman, which sailed smoothly, Cox stated that he would ensure that option expensing is implemented.

In 2004, IRRC tracked votes on option expensing proposals at 34 companies, of which 20 received support from a majority of votes cast. The average level of support overall was 53 percent.

Ability of board to implement proposal disputed

The SEC said several resolutions asking companies to appoint an independent board chair could be omitted because they were beyond the power of the board to implement under Rule 14a-8 (i-6). One of those omitted was a proposal urging Exxon Mobil to amend its bylaws to require that an independent director serve as chair and that the chair not serve

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concurrently as CEO. "As it does not appear to be within the power of the board of directors to ensure that its chairman retains his or her independence at all times and the proposal does not provide the board with an opportunity or mechanism to cure such a violation of the standard requested in the proposal, it appears that the proposal is beyond the power of the board to implement," the SEC said in its decision.

The proposal was submitted by the RAM Trust Services, which counts noted governance activist Robert A.G. Monks among its directors. RAM Trust, with its law firm, Grant & Eisenhofer, appealed the no-action ruling to the full commission. The appeal argues that the proposal is not beyond the power of the board to implement because it is precatory and does not "require" any action. If the proposal passed and the board decided to implement it voluntarily, the board still would not have to "ensure" or "guarantee" that the independence requirement in the proposal would be met, says the appeal. "This is simply not a requirement of the proposal," it adds.

The appeal also takes issue with the SEC's statement that the proposal is beyond the board's power to implement. It points to the requirements in the Sarbanes-Oxley Act that the board appoint independent directors to the company's audit committee and to stock exchange requirements that various committees be comprised of independent directors and that a majority of the board be independent. "The staff's determination that companies such as Exxon Mobil lack the capacity to appoint an independent director to the position of chairman and/or "to ensure that its chairman retains his or her independence at all times" therefore calls into question corporations' abilities to comply with any of these legal requirements as well as the commission's authority to promulgate such rules," says the appeal.

The attorneys for RAM Trust also point out that in the past the company has not argued that its board was not capable of implementing such a proposal. Similar proposals appeared in Exxon Mobil's proxy statements and garnered 21.5 percent of the votes cast in 2003 and 27 percent in 2004. "Exxon Mobil never claimed that it lacked the ability to implement the proposal until, by its own admission, it became aware that the staff was allowing other companies to exclude similar proposals based upon the fiction that a company cannot implement a proposal establishing a director qualification unless it can first 'ensure' that shareholders will, in all conceivable circumstances, elect sufficient directors meeting the qualification," says the appeal.

Despite the appeal, the SEC let the no-action decision stand, and the proposal did not appear in the company's proxy statement. On his Web site, Monks calls the decision "arbitrary and capricious censorship by the SEC."

Labor Funds' Negotiations Spawn Withdrawals in 2005

Each year, after the filing of resolutions, comes the long—and often arduous—process of shareholder negotiations with companies. The prize, after all, is not the highest vote, not even the passage of proposals that are in any case only advisory: the goal for proponents is to effect real change at corporations. Sometimes reforms are created piecemeal—company-by-company. In other cases, shareholder resolutions join other public pressure that may ultimately tip toward change.

Proponents affiliated with labor funds have often been astute at calculating what their potential achievements could be. In years past, proposals were frequently withdrawn for no greater reason than a good faith effort by management to enter into discussions. That has become less standard. Though a willingness to listen and share information goes a long way, IRRC tracks fewer proposals each year that are withdrawn on the basis of "substantive discussions" alone. While "relationship building" and the possibilities of continued dialogue continue to be valued highly by proponents who see their engagement with companies to be a long-term project, this article focuses on those proposals that were withdrawn in proxy season 2005 based on specific actions taken by companies in the face of proposals from labor union funds.

Compensation proposals at center stage

Among the labor funds generally, the building trades funds have filed the largest number of proposals, and have also withdrawn the highest number of proposals. Ed Durkin, director of the Corporate Affairs department for the United Brotherhood of Carpenters and Joiners explained the process the funds go through to IRRC. Before filing a compensation proposal at a company, for example, the fund first does a thorough analysis of the company's current compensation program, using a "Commonsense Executive Compensation Scorecard." The scorecard is based on a set of best practices identified by the funds over the past several years that go under the "commonsense" rubric. Under the scorecard, the company is awarded points on 28 factors in a range of categories, including CEO salary, CEO long-term compensation, severance plans and supplemental pension plans. Under the category of "compensation committee disclosure," for example, a company received two points if it clearly describes its peer group or four points if it identifies its peer group companies. The scorecards, which are frequently shared with the companies, are used to focus the funds' negotiations with the companies.

In part because of the format of the scorecard, and in part because the principle of disclosure is such an important one to labor shareholder activists, disclosure is a factor in many of the withdrawals this year. In fact, of the 23 compensation proposals withdrawn on the basis of management action (short of full implementation), 15 included some feature of increased disclosure. "Disclosure is the next place compensation reform has to go," says Durkin.

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The features graded in the scorecard also are the principles that form the basis of the "implement commonsense executive compensation reforms" proposal, filed by building trades proposals for the second time this year. The proposals seek to overhaul companies' executive compensation practices and replace them with a number of commonsense features, including, for example, targeting the CEO salary at no higher than the median of salaries paid at peer group companies, with variances fully explained. It is not surprising, then, that disclosure was a factor in four of the five withdrawn proposals. For example, the Carpenters withdrew such a proposal at Harley-Davidson after the company agreed to one of the broadest disclosure improvements of any company: it will disclose stock ownership guidelines, the names of individuals covered by SERPS, and the number of people covered by change in control agreements. The executive compensation table also will include more information on perks, among other improvements. Representatives from the Sheet Metal Workers International Association (SMWIA) concluded, "Overall, this is not exactly what we have asked for, but it is progress in the right direction." The Carpenters withdrew the proposal at Lehman Brothers after the company agreed to name the compensation consultants retained by compensation committee, to name its peer group companies, and to report on a detailed list of performance measures used to determine total compensation for executive officers, among other increased disclosure.

"We'll never get to solid pay for performance until we have better disclosure," says Durkin. One arena where the issue is important is specific disclosure of criteria for performance-based compensation and disclosure of the peer groups the company uses to analyze its own compensation practices. Durkin notes, "Until you get that stuff down, it is difficult to compare companies within peer groups." The Sheet Metal workers agreed to withdraw a performance option proposal at Potlatch after the company agreed to identify by name the 30 peer companies in the peer group used to determine base salary, short term incentives, and long term incentives (as well as additional disclosure.) Other companies that agreed to disclose by name peer group information include: Cinergy, Lehman Brothers, and Merrill Lynch.

Durkin compares the sorts of steps the trades are achieving now with those achieved in the past on auditor independence. The building trades' filing of what was then a novel proposal in 2002, which was filed in the fall of 2001, coincidentally coinciding with Enron's collapse, and the issue drew high levels of support in its first year. The second year the proposal was filed a number of companies adopted some reforms. "We got some pre Sarbanes- Oxley substantive changes, combined with disclosure. The disclosure required now is much better." He is hopeful that disclosure on compensation may follow a similar path, perhaps even with an SEC rulemaking on the topic. "Shareholders obviously support it," he says, "And even with the companies we talked to there's broad support for more specific and detailed compensation disclosure."

Although many of the proposals filed by the building trades seek the adoption of specific broad policy changes, proponents understand that the adoption of compensation reforms such as indexed options, for example, is unlikely. As Durkin notes, "few companies are willing to get ahead of the curve" in adopting such measures, but many are willing to enter into substantive conversations about their compensation practices.

Twenty of the 35 proposals filed by the funds seeking performance-based options were withdrawn, and nine of the 16 proposals seeking performance-based restricted stock that the funds filed were subsequently withdrawn. A current trend in compensation is reducing the use of options and relying more heavily on restricted stock. Labor funds have been vocal in encouraging this trend and insisting that the restricted stock should include performance criteria. In some cases, proposals filed on these topics may have helped hasten the adoption of such changes that may have already been in the works. For example, the SMWIA withdrew a performance options proposal at Washington Mutual after conversations with the company based on "changes that were contemplated prior to the meeting—though not necessarily prior to the filing of the resolution." Among the changes will be a reduction in the role of fixed-price options and an increase in the role of performance shares and performance-contingent grants of restricted stock. The company will also disclose ownerships requirements for top executives, including, for example that the CEO be required to own stock at ten times his base salary. The ownership guidelines also will require executives to retain all grants of restricted shares under they have met their requirement.

In a number of other cases, discussion with the companies revealed that since the publication of the 2004 proxy statement the company had already adopted changes that satisfied the proponents when they heard of them, or has particular reasons for its current practices. This seems to be particularly true of proposals related to performance-based restricted stock. For example, Morgan Stanley had already decided to: increase the amount of CEO incentive pay that is paid in equity to 65 percent; end the use of stock options in favor of restricted shares and stop discounting restricted shares, and the Carpenters withdrew a proposal there. Citigroup had also updated its compensation policies in 2004, and SMWIA withdrew a restricted shares proposal there. In discussions with Motorola, SMWIA fund representatives learned that the recent grant of a restricted stock there was related to the appointment of a new CEO, and agreed to withdraw the proposal and look at the issue again next year.

Similar withdrawals were related to performance options proposals. The Carpenters withdrew a proposal on performance options at Pitney Bowes after the company explained that 50 percent of executive long-term compensation is awarded in cash incentive units based on performance criteria. The company agreed to clarify this in the proxy statement, and increase disclosure of target and maximum amounts for annual incentive awards, as well as to include a description of the weighting of financial vs. strategic objectives. The Carpenters also withdrew a performance options proposal at BellSouth after the company noted that it had not issued stock options in 2004 and 2005. In conversations at Fluor, the SMWIA learned that the company uses "career shares" that require 10-year vesting as one feature of their compensation, and agreed to withdraw its performance-based options proposal on that basis, and "in favor of developing ongoing communication with Fluor." SMWIA also withdrew a performance options

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proposal at Dow Chemical after the company detailed its move away from options and into greater reliance on performance shares.

The building trades were not the only proponents to file on compensation issues. The AFL-CIO filed 13 proposals seeking performance-vesting equity compensation (both options and restricted stock), of which only two have been withdrawn (one for a technicality). The AFL-CIO entered into significant negotiations on the proposal with AFLAC. In the letter of agreement to verify the withdrawal, Joey Loudermilk, General Counsel of AFLAC wrote to Brandon Rees, "AFLAC will disclose in its 2005 proxy statement that a significant portion of future equity compensation grants for its named executive officers … will be in the form of shares of stock that require the achievement of performance goals as a condition of vesting. Moreover, AFLAC will disclose in its proxy statement any performance goals actually set for its named executive officers during the preceding year (provided that AFLAC will not disclose information it considers to be confidential commercial or business information, the disclosure of which could have an adverse effect on AFLAC)." AFLAC also announced in February that it would begin expensing options effective January 1, 2005.

In general, few proposals on option expensing were withdrawn in 2005, other than several that were withdrawn after the SEC ruled that the proposals could be omitted. There were some exceptions, however. The Laborers' fund withdrew a proposal at Texas Instruments after the company agreed that they would expense options, regardless of the outcome of lobbying efforts against expensing. Apple Computer convinced the Carpenters that the company was not involved in the lobbying effort against the FASB rule and is prepared to implement expensing, and the Carpenters withdrew their proposal.

Golden parachutes and severance policies continue to be the compensation issue where companies seem most willing to actually adopt new policies. The policies differ tremendously, however. Funds affiliated with the International Union of Bricklayers and Allied Craftworkers (BAC) withdrew two such proposals after Circuit City Stores and Starwood Hotels and Resorts adopted the requested policies. The Service Employees International Union (SEIU) fund withdrew proposals at Archstone Smith and Brandywine Realty after those companies addressed some of the proponents concerns; and the LongView fund withdrew a proposal at CSX after that company adopted a policy.

The details of these policies vary considerably, however. On March 25, Starwood adopted a policy that, unless approved by a majority of stockholders present in person or by proxy at an annual or special meeting at which a quorum is present, the company will not enter into an agreement with an executive officer that provides severance benefits that exceed 2.99 times base salary plus most recent bonus of such executive. Starwoods's policy explicitly states that it shall in no way affect any existing severance agreement or an amendment to an existing agreement, unless that amendment increases the formula for determining severance benefits. Starwood defines benefits as: cash payments following termination of employment, including, but not limited to lump sum severance payments, periodic cash payments, and payments for consulting fees or salary continuation. Circuit City's policy, adopted effective June 21, 2005, also excludes renewals of existing employment agreements, but defines benefits included a bit more broadly, including "the value of post-termination employee benefit plan and fringe benefit continuation and additional service credit to defined benefit pension plans."

Under both the Starwood and Circuit City policies, the value of accelerated vesting of stock options and other long-term incentive awards is not subject to the 2.99 multiple limit. Both Starwood and Circuit City include language that stipulates that the companies will continue to pay "gross ups" or "penalty tax reimbursements." The companies use nearly identical language to explain that, "Such payments do not increase the after tax value of benefits and therefore will not count for purposes of the 2.99 times limit." Jake McIntyre, Assistant to the Secretary Treasurer at BAC, noted that the policies were not entirely what the fund sought, but said they were "good solid policies" and that the fund opted to "maintain good will between the fund and the company by withdrawing" the parachute resolutions.

CSX announced January 24 that it would begin immediately to seek shareholder approval for new severance packages for senior executives that exceed 2.99 times annual compensation of base salary plus bonus, and the LongView Fund withdrew its binding proposal at the company. The CSX board decided to enact this change after a golden parachute proposal submitted by the Amalgamated Bank's LongView Funds garnered the support of 73 percent of the votes cast in 2004.

Proposals related to auditor issues

Again in 2005, the building trades funds raised issues related to auditors. The funds believe that shareholders should have the right to ratify auditors, and in many cases companies receiving that resolution adopted it. For example, the proposal was withdrawn after companies agreed to put an auditor ratification proposal in the proxy statement at Cincinnati Bell, Halliburton, Pepco Holdings, PNC Financial Services, Potlatch, and Xcel Energy. These settlements bring to nearly 100 the number of companies that have agreed in the past two seasons to allow shareholders to communicate via an auditor ratification proposal.

The Carpenters also withdrew a proposal at Xcel Energy that sought to limit consulting by auditors. As of 2004, the company's auditor consults only on limited tax functions, so the proposal had essentially been implemented. Additional, more current information provided by companies to proponents was enough to convince the fund to withdraw two similar proposals. The Carpenters withdrew a proposal at Fifth Third Bancorp after learning that the 2005 proxy statement showed substantially reduced tax fees. Illinois Tool Works explained that the non-audit work figures reported in their proxy were related to preparation of tax returns for foreign subsidies, and that work actually pre-dated the audit contract, and SMWIA withdrew that proposal as well.

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Majority vote to elect directors—withdrawals signal victory

Fifteen proposals calling for the election of directors by a majority vote were withdrawn by building trades funds after the companies agreed to participate in a working group with the funds to explore how such a procedure might be implemented. After the proponents filed, several companies responded substantively, wanting to engage the issue, according to Durkin "not to negotiate away the proposal, but just in good faith responding to the proposals." The funds eventually invited these companies to join them in the formation of a working group.

The companies, including Cinergy, Time Warner, Wyeth and Intel, agreed to study with shareholders the merits and logistical issues of requiring directors to be elected by majority votes, according to the terms of a settlement agreement with union pension funds. Under the settlement, companies agreed to participate in a "Majority Vote Work Group" comprised of corporate representatives and pension fund representatives in order to "examine all aspects of the director majority vote standard issue." The goal of the group is to "promote informed shareholder and corporate consideration of the director majority vote standard issue." The group is to meet three times prior to November "to study legal and practical issues associated with the adoption of a director election majority vote standard." After the third meeting, the group will present its findings on the majority vote issue, identify areas of agreement and disagreement among the participants, and outline possible continued joint collaboration on the issue. "At the end of the process, we may have differences of opinion," said Durkin, But "the work group will be a constructive vehicle for advancing informed consideration of this issue."

The majority vote committee held its first meeting, which Durkin described as very positive, in May. Twenty-three people, including representatives from 14 companies, attended the meeting in Washington DC, where the group outlined various issues relating to majority voting and implementation that they will study at subsequent meetings.

Two additional companies, Lowe's and Dillards, had the proposal withdrawn when they agreed to implement majority voting.

Other board-related proposals

Real success for a proponent occurs when management simply implements a proposal—or commits to seeking implementation—and this is most cut and dried with generally accepted "best practice" governance issues such as those related to classified boards. In 2005, four resolutions filed by labor funds to declassify boards were withdrawn when management agreed to put forth a board proposal to elect all directors annually. Yet even these withdrawals vary somewhat. At George Pacific, for example, the LongView fund agreed to withdraw based on a management proposal even though management stated it opposed the proposal, which did not pass. AFSCME withdrew the proposals at Ingersoll Rand, Morgan Stanley and Raytheon after the companies agreed to put management proposals on the proxy (preliminary results indicate that the resolutions at Morgan Stanley and Raytheon passed).

In addition, the BAC fund withdrew a proposal to declassify the board at Best Buy after discussions with the company in which they defended their 2-year, as opposed to 3-year, classified board. "In that particular circumstance they made a compelling case for why a strictly limited classified board was appropriate at that particular company," said McIntyre.

The LongView fund withdrew two proposals related to board independence. At AutoNation additional information on the directors was enough to inspire the fund to withdraw a proposal to increase board independence. The proposal for an independent board chairman at Electronic Data Systems was withdrawn after substantive dialogue with the company. The company agreed to disclose in the proxy its position on this issue, and to consider it for the future. The proponent understands that given recent broad personnel changes this may not be the time for enacting this change.

Proposals to insurance companies also find favor

The AFL-CIO launched a campaign to urge insurance companies to report on sales practices including its use of contingent commissions, recent revelations of bid rigging and price fixing in light of a number of media reports in 2004. The fund subsequently withdrew the proposals at four companies (Marsh and McLennan, Hartford, ACE Ltd. & Prudential). Daniel F. Pedrotty, Financial Initiatives Counsel at the AFL-CIO Office of Investment, notes that while they "were pleased with the responses we received from each company, the degree of engagement and responsiveness from two was especially impressive: Marsh and McLennan, and Hartford." Marsh appointed a new Compliance Committee consisting of three independent directors and a new Senior Vice President and Chief Compliance Officer. Hartford's CEO Ramani Ayer committed to making public the results of the Company's internal probe, and the company agreed to consider the AFL-CIO's input on how the public disclosure of probe results should be made. Pedrotty notes that the AFL-CIO "also convened a valuable and constructive conference call with two independent members of The Hartford's board of directors—Edward J. Kelly, III, chairman of the audit committee; and Charles B. Strauss, chairman of the legal and public affairs committee."

The willingness to make board members available to hold discussions with the proponents is important to the AFL-CIO, as it is to many other proponents, and the AFL-CIO adds that it prefers that company representatives not participate in these discussions. Pedrotty notes, "We feel it's important to engage directors without management present to allow for a candid and straightforward discussion between shareholders and their independent representatives at the company."

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Preliminary 2005 Postseason Report

Corporate Governance at a Crossroads

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Introduction

By Ted Allen, Director of Publications

This 2005 proxy season has featured a series of crossroads in corporate governance for institutional investors, companies and regulators.

With the momentum for post-**Enron** and **WorldCom** reforms fading in the U.S., there is less enthusiasm for new regulation and more calls to reassess the costs and benefits of those measures. While most investors and companies still agree that the Sarbanes-Oxley Act of 2002 and other governance reforms were necessary to restore investor confidence, there are increasing complaints from companies about compliance costs, particularly on internal control reporting.

Director Elections

While many institutional investors remain interested in increasing their influence on corporate boards, they have taken a different road toward that goal this season. In perhaps the year's most significant development, they have voted in surprising numbers for majority election proposals filed by the **United Brotherhood of Carpenters and Joiners** and other unions.

Last year, investors advocated for the **Securities and Exchange Commission**'s proxy access proposal to establish a procedure to nominate directors. However, that draft rule was criticized as too complicated and ran into determined opposition from business groups. Even SEC Chairman William Donaldson, who made proxy access a priority, said in February that the SEC staff should start over. And with Donaldson's retirement in June, it appears quite unlikely that proxy access will be revived.

Meanwhile, more investor advocates, including the **California Public Employees' Retirement System** (CalPERS) and the **Council of Institutional Investors**, have joined the effort to push for majority elections. At more than 50 companies so far this season, the level of support has averaged around 45 percent.

Takeover Defenses

While some U.S. companies continue to disregard investor wishes on poison pills and board declassification, a larger number have chosen the path of engagement this year. For the first time, the number of management proposals to declassify boards has outstripped those submitted by shareholders. More companies are redeeming their poison pill plans early, submitting those defenses to shareholder approval or moderating some of their features.

Overall, fewer shareholder proposals have been filed this season. About 570 have made it on company ballots so far. The total for the 2005 likely will fall short of the full calendar year tallies for 2004 (708 proposals) and 2003 (698). In addition, fewer shareholder proposals have won majority support. So far, 85 proposals have done so this season, compared to 138 in 2004 and the all-time high of 172 in 2003.

Hedge Funds

At the same time, state and union pension funds have chosen a quieter and less public road this year. Last year, they were involved in high-profile "vote no" efforts at **Walt Disney** Co., **Safeway** and **MBNA**. At Disney, investors rallied a 45 percent withhold vote against CEO Michael Eisner, prompting the board to strip him of his chairman title and agree to other governance reforms. Apparently satisfied by these steps, investors overwhelmingly voted to reelect Eisner and other Disney directors this year.

In their place, financier Carl Icahn and an array of hedge funds have become more active, pressing for change through proxy contests at **Blockbuster**, **BKF Capital** and other firms. While management has questioned their motives, the dissidents' appeals to shareholders have included various corporate governance improvements. As they make longer-term investments in companies, hedge funds managers are increasingly embracing reforms like board declassification.

At the same time, there have been fewer proxy fights, as some companies have reached settlements with dissident investors. Prominent examples of averted proxy contests include **Beverly Enterprises** Inc. and **Kerr McGee** Corp. So far this year, there have been only 11 proxy contests. That compares to 19 during all of 2004 and 30 in 2003.

Meanwhile, shareholders who lost billions of dollars in corporate accounting scandals finally know that they will get some money back. Investors led by the **New York State Common Retirement Fund** have negotiated more than $6 billion in settlements with WorldCom's former investment banks, auditor and directors. Meanwhile, the **University of California** has negotiated $4.7 billion in settlements from Enron's ex-bankers, auditor and directors, and likely will obtain additional settlements.

Around the world, lawmakers and regulators are responding to their own corporate scandals and moving gradually to adopt codes of conduct, board independence rules and other governance reforms. Examples include Belgium, Sweden, Turkey, Colombia, and Mexico. In addition, the Netherlands and other countries are expanding the rights of investors to bring securities fraud lawsuits against companies. In the past year, the European Union has adopted stock-option expensing and sought to remove barriers to cross-border mergers. The EU is continuing work on a directive to enhance shareholders' rights to participate in company meetings.

Crossroads at the SEC

Back in the U.S., the SEC is at a clear crossroads following Donaldson's departure. Democratic Commissioner Harvey Goldschmid, an advocate of proxy access and other reforms, is also leaving the SEC this summer, while the term of Democrat Roel Campos has expired. In a series of 3-2 votes, Donaldson voted with Goldschmid and Campos to enact various reforms, including new hedge-fund registration requirements and independence standards for mutual fund boards. During Donaldson's tenure, the agency significantly increased its enforcement efforts and recoveries for investors.

Rep. Christopher Cox, who has been nominated by President George W. Bush to lead the SEC, is expected by both investors and companies to take a less regulatory approach. Cox is best known for espousing free-market ideals, opposing stock-option expensing and writing 1995 legislation to limit securities lawsuits. Although some investors hope that Cox will carry on Donaldson's efforts to push for better disclosure of executive compensation, other expect that he will be skeptical of new regulation. While most SEC observers do not anticipate that Cox will push for a broad rollback of the Sarbanes-Oxley reforms, he likely will take a different path than Donaldson.

"The whole future of the SEC is up for grabs," John Coffee, a securities law professor at **Columbia University**, told Bloomberg News.

Highlights of SEC Chairman William H. Donaldson's Tenure

February 2003: Donaldson succeeds Harvey Pitt as chairman of the Securities and Exchange Commission. Donaldson increases enforcement of the Sarbanes-Oxley Act to improve corporate accountability.

July 2003: Donaldson endorses a proposed rule to allow the nomination of directors by investors. Also, the SEC releases a study on the adoption of a principles-based accounting system that leads to the creation of the **Public Company Accounting Oversight Board** (PCAOB).

October 2003: The SEC staff releases a draft proxy access rule, known as Rule 14a-11. The proposal attracts support from some institutional investors, but is opposed by business groups and Treasury Secretary John Snow.

November 2003: The SEC adopts rules on the disclosure of nominating committee functions and communications between investors and boards of directors.

March 2004: The SEC holds a roundtable on its draft proxy access rule.

June 2004: Donaldson backs a rule requiring mutual fund chairs to be independent from the companies that manage the funds. The measure passes 3-2, with Donaldson siding with the SEC's two Democratic commissioners. The rule, requiring mutual funds to have boards with 75 percent independent directors, including an independent chairman, was slated to take effect in January 2006. After a legal challenge by the **U.S. Chamber of Commerce**, a U.S. appeals court in June 2005 ordered the agency to reconsider the rule, concluding that the SEC did not properly consider the potential costs of the measure. At his final SEC meeting in June 2005, Donaldson joined another 3-2 vote to revive the rule.

October 2004: In another 3-2 vote, the SEC adopts a rule requiring the registration by financial advisers managing more than $25 million of hedge funds assets for 15 or more clients. The rule would also subject advisors to routine SEC inspections; it is scheduled to go into effect in February 2006.

February 2005: Donaldson tells reporters that the SEC staff will have to start over on proxy access. Two months earlier, the SEC staff reversed course and allowed the **Walt Disney** Co. to omit a proxy access proposal by investors that was modeled after the draft SEC rule.

March 2005: The SEC votes unanimously to allow mutual funds to impose penalties for rapid trading, or selling fund shares within seven days of their purchase.

April 2005: In another 3-2 vote, the SEC approves a "trade through" rule, requiring investor orders to buy or sell stock to be filled at the best price, as long as the order can be executed immediately. The rule, which is to be implemented by June 2006, aims to reconcile prices and electronic-speed trading as the **New York Stock Exchange** moves toward an electronic platform. In another development, the SEC extends the deadline for companies to start expensing stock options until the start of their next fiscal year.

June 2005: Donaldson announces his resignation, effective at the end of the month. Rep. Christopher Cox is named by President George W. Bush to lead the SEC.

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Chart 1: Shareholder Support on 12 Key Issues
(based on percentage of votes cast)
January to June 2005

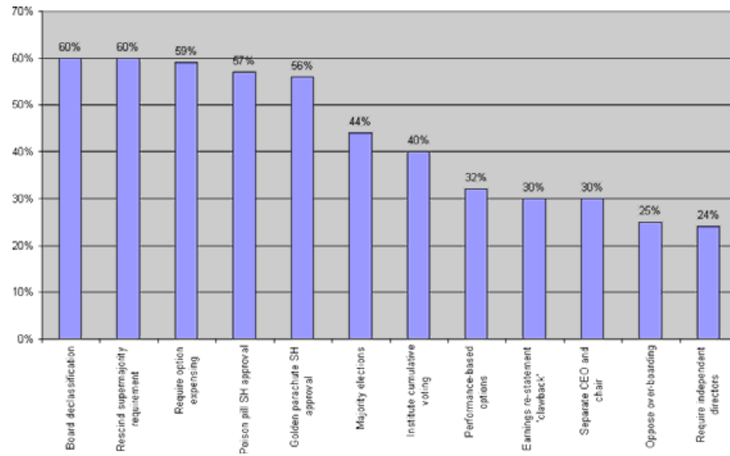
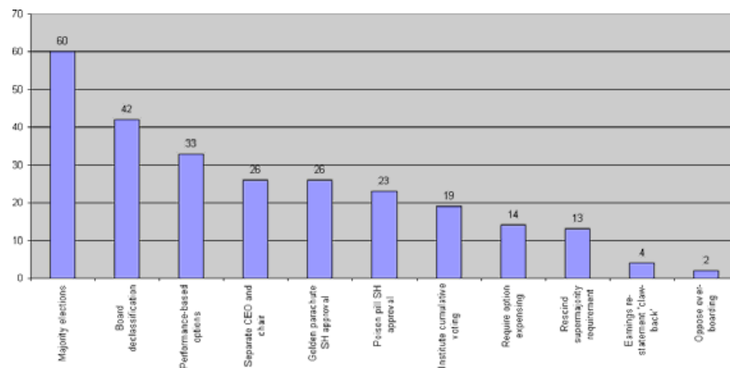


Chart 2: Number of Shareholder Proposals Filed on 12 Key Issues
(includes only U.S. companies monitored by ISS, January to June 2005)



Investors Show Strong Support for Majority Elections

By Thaddeus C. Kopinski, Staff Writer

Judging by the number of shareholder proposals filed on the topic this proxy season, majority voting in director elections is rapidly becoming a top priority in the area of corporate governance. The reform would transform the way corporate directors are elected in the United States, and it holds the potential to enable a new era in constructive dialogue between corporations and their owners. Momentum is growing to embrace majority voting, or at least consider it with great care.

So far this year, majority election proposals have received majority support from investors at about a dozen companies. At more than 50 meetings so far, the average level of shareholder support has hovered around 45 percent, compared to 12 percent at 12 meetings last year, according to ISS data.

The highest support levels were posted at **Altera** Corp. (59 percent) and **Advanced Micro Devices** (58 percent), and the lowest (19 percent) at **Amazon.com** Inc. and **Ecolab** Inc. (22 percent).

"We had high expectations for the director election majority vote proposal and the results to date are stronger than those expectations," according to Ed Durkin, director of corporate affairs at the **United Brotherhood of Carpenters and Joiners**, which has taken a lead on this issue.

The Carpenters union alone has filed more than 40 majority elections shareholder proposals this proxy season. "The surprisingly high votes are a clear signal from shareholders that it's time to move to majority voting for directors," Durkin said.

To further the issue, the Carpenters union and three other building trades unions formed a working group with representatives from 13 major companies to examine how to implement majority elections. The group is scheduled to issue a final report by late fall.

"Our hope is that a report coming from a group of both institutional investors as well as issuers will help inform the debate, and I think will make the point that a majority vote standard obviously can be implemented," Durkin noted.

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The list of participants of the corporate-institutional investor working group:

Corporations	Unions
Baxter International Inc.	United Brotherhood of Carpenters and Joiners
Chevron Texaco Corp.	Laborers' International Union of North America
Cinergy Corp.	Sheet Metal Workers International Association
Citigroup Corp.	United Association of Journeymen and Apprentices of the Plumbing and Pipe Fitting Industry of the United States and Canada
Constellation Energy Group Inc.	
Dow Chemical Co.	
El Paso Corp.	
The Gap Inc.	
Intel Corp	
J.P. Morgan Chase & Co.	
Merrill Lynch & Co.	
Time Warner Inc.	
Wyeth	

This interest in majority elections marks a major shift from a year ago, when investor efforts to reform director elections focused on an alternative--the shareholder access rule proposed by the Securities and Exchange Commission in October 2003. The proposal, which was opposed by business groups and Treasury Secretary John Snow, has languished and appears dead, following the retirement of SEC Chairman William Donaldson, who had made proxy access a priority. Before the start of the 2005 season, the SEC staff angered some investors when it reversed course and allowed **Walt Disney** Co., **Halliburton** Co. and other companies to omit shareholder proposals that were modeled after the draft SEC rule.

Earlier this year, the **Central Laborers' Pension Fund** and other investors negotiated for the right to nominate directors through securities lawsuit settlements with **Ashland** Inc., **Hanover Compressor**, **Broadcom** and **Microtune**, according to news reports. A fifth company, **TXU** wouldn't accept this change but did agree to replace two board members, ensure that at least 70 percent of the board members are independent, create a lead independent director and rescind its poison pill.

Growing Support for Majority Elections

The **Council of Institutional Investors**, at its annual membership meeting in April, adopted a policy endorsing majority elections. In March, the **California Public Employees' Retirement System**, the nation's largest public pension fund with assets of more than $186 billion, adopted a three-pronged plan to advocate majority elections.

In June, **Pfizer** Inc. announced that the board had amended the company's corporate governance principles to require that any director who receives a majority of withhold votes must submit his or her resignation; the board will in turn consider the resignation and make its recommendation.

Also that month, **N-Viro International** Corp. said it would introduce a management proposal to implement majority elections. Earlier, home building supplier **Lowe's** Cos. announced in its 2005 proxy that its governance committee has begun a review of the process to provide that director nominees be elected by a majority of votes cast. Any required shareowner action to implement the majority vote standard will be submitted for approval at the company's 2006 annual meeting. And in April, **Dillard's** Inc., meanwhile, announced that its board will also consider the issue.

To its proponents, majority voting is a question of democratic principle. They argue that the reform would transform the current symbolic process, in which shareholders can withhold their votes but cannot vote against directors, to a democratic and meaningful election. Directors would be accountable to shareholders and would face the real risk of losing the election and thus their seat on the board.

Critics question the need for majority voting and counter that majority voting would open a Pandora's box of unanswered questions and unintended consequences. How would directors who lose elections be removed from the board? Would sudden removals destabilize or even decapitate the board? How would "withhold" votes and broker non-votes be counted? Would majority voting restrict the director candidate pool? Would it halt governance reforms such as annual elections? And last but not least, what is the appropriate venue to pursue reform--state law, federal regulation, exchange listing standards, or shareholder proposals at individual companies?

ABA Task Force

A task force of the **American Bar Association's** corporate law committee is examining the various implications inherent in this complex issue. The task force has prepared a discussion paper and has invited the public to submit comments by Aug. 15. The ABA paper outlines four options and discusses their potential benefits and problems:

- Retain the current plurality vote default rule.
- Change to a majority vote default rule.
- Adopt a default plurality rule requiring that a director must be elected by at least a "minimum" plurality vote, such as one-third.
- Leave the plurality vote default rule in place but specifically authorize "against" votes with consequences where a director achieves a plurality vote but more "against" than "for" votes. These consequences could include, for example, shortening the term of that director, unless the board acted within a specified time frame to confirm the director's election, or giving the board the authority to remove that director.

The committee consists of practicing lawyers, academics, in-house counsel and judges from 20 states. The committee is chaired by E. Norman Veasey, a retired chief justice of the Delaware Supreme Court. The task force is co-chaired by Margaret M. Foran, vice president and secretary for corporate governance at Pfizer, and A. Gilchrist Sparks III, a partner in the Delaware law firm of **Morris, Nichols, Arsht & Tunnell**.

The **Business Roundtable** (BRT) sent a letter to the ABA task force, urging "careful consideration of the 'complications' any new standard would present." In addition to the issues raised by the ABA, the BRT cited these concerns: "shareholder confusion and solicitation costs; increased difficulty in finding qualified and willing directors if director elections come to resemble political style campaigns; and increased power of special interests to advance narrowly focused or single-issue viewpoints that may not reflect long-term shareholder value."

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Anti-Takover Measures Under Greater Scrutiny

By Thaddeus C. Kopinski, Staff Writer

Since the 1980s, management and shareholders at many U.S. companies have clashed over the wisdom of takeover defenses like poison pills, classified boards and supermajority voting rules. To management, these measures are necessary protections against unwanted suitors and boost share value. On the other hand, some investors argue these defenses can shield companies from accountability and entrench unresponsive management and directors.

What's changed this season is that more U.S. companies are heeding investor demands to drop these defenses or put them to a shareholder vote. For the first time, the number of management proposals to declassify boards has outstripped those submitted by shareholders. In addition, a growing number of companies are agreeing to drop supermajority-voting requirements on change-in-control matters in favor of a simple majority standard. Finally, a handful of U.S. companies filed management proposals to submit poison pills to shareholder approval, or at least to moderate some of their features.

Some Poison Pill Refinements

Among the U.S. companies that submitted poison pills (also known as "shareholder rights plans") to investor approval this year are **Ryan Restaurant Group** Inc., **Catellus Development** Corp. and **GMX Resources** Inc. Others, like **WatchGuard Technologies** Inc. adopted a poison pill, but included a so-called "sunset provision" which would terminate the pill by next year's annual meeting, unless the majority of votes cast specifically endorses extending it.

Advocates of submitting poison pills for shareholder approval note that a growing number of poison pill plans contain self-limiting features. Such "shareholder-friendly" features include a three-year independent director evaluation, a sunset provision, a qualified offer clause, and a trigger threshold of 20 percent or more.

At the same time, shareholders this year continue to back proposals to curtail pills. At 17 companies at which shareholders filed proposals to submit poison pills to investor approval, the level of support has averaged about 60 percent. Those proposals won a majority of votes cast at 12 of those companies. The average level of investor support is about the same as in the preceding two years, but the total number of proposals filed has dropped from 78 in 2003 to about 50 last year and to 23 so far this season.

Caterpillar Inc., which had seen significant (48 to 59 percent) investor support for poison pill proposals for the past six years, announced in June that it would drop its pill 17 months early. **Wintrust Financial** Corp. has announced that its pill would expire in 2005, rather than 2008. Other firms that have terminated their poison pills early this year include **Electronic Data Systems** Corp., **Morgan Stanley**, and **Cisco Systems** Inc.

Some companies haven't been swayed by these proposals. **R.H. Donnelly** Corp., **Maytag** Corp., **Alaska Air Group** Inc. and the **Pep Boys** are among the firms that have seen majority votes on investor proposals to submit poison pills to shareholder approval for at least three years running.

In addition, some companies have adopted poison pills without seeking shareholder approval or setting time limits. Among the latest are **Main Street Restaurant Group** Inc., **Neurobiological Technologies** Inc., **Axonyx** Inc., **JPS Industries** Inc. and **Pain Therapeutics** Inc., as well as Canada's **Harvest Energy** TR.

Supermajority Requirements

As in past years, shareholders have backed resolutions to rescind supermajority-voting rules on most matters subject to shareholder approval. Shareholder proposals to switch to a simple majority standard have gained majority support in all but one case (**Station Casinos** Inc. with 26 percent). At 11 companies so far this year, the average level of support was 60 percent, somewhat lower than the 74 percent posted last year (See Chart 1).

For some companies like the **Boeing** Co., shareholder proposals to abolish supermajority requirements have garnered majority support for four years in a row. About a dozen management proposals on the subject got more than 90 percent this year. The only company at which it failed to gain a majority was **Enercorp** Inc.

Board Declassification Groundswell Builds

This year, for the first time, the number of management proposals (49) on board declassification has exceeded those (42) filed by shareholders (See Chart 2). This represents almost twice the number of total proposals on this issue filed only three years ago; almost all of the increase was accounted for by management proposals, which increased seven-fold in this time period.

At 28 companies so far, the level of support for shareholder proposals seeking annual director elections has averaged 61 percent. This compares with 71 percent last year and 63 percent in 2003. At five companies this year, those proposals won more than 80 percent support. As was to be expected, most management proposals got in excess of 90 percent.

For the past three years, majority votes on shareholder declassification proposals have been posted at **Luby's** Inc., **Sempra Energy**, the **Stanley Works** and Boeing. **Boston Properties** Inc. and **Centerpoint Energy** Inc. have seen majority votes on the issue for two consecutive years.

Maytag, where a non-binding shareholder proposal garnered only 45 percent this year, has the distinction of getting majority support on this issue for the six preceding years, with last year's result hitting 67 percent. This year, the company sponsored its own declassification proposal, which got 86 percent of votes cast, but not enough to meet the two-thirds of shares outstanding required to pass.

Cumulative Voting Proposals

The number of shareholder proposals seeking to institute cumulative voting has remained fairly steady over the past three years, hovering around 20 per annum. With more than half of the companies with this issue on the agenda this season reporting results, the average level of support has inched upward from 35 percent in 2004 to 39 percent this year.

The issue won a majority of votes cast at **Storage Technology** Corp and **Alaska Air Group** Inc., with 54 and 56 percent respectively. Next highest was **General Motors** Corp. with 49 percent.

Cumulative voting permits a shareholder to amass (cumulate) all his or her votes for directors and apportion these votes among one, a few, or all of the directors on a multi-candidate slate. For example, consider a company with a ten-member board and 500 shares outstanding. The total number of votes that may be cast is 10 x 500, or 5,000. In this case, a shareholder with 51 shares (10.2 percent of the outstanding shares) would be guaranteed one board seat because all of the shareholder's votes may be cast for one candidate. This provision facilitates the election of minority representatives to the board and can be particularly significant in proxy contests where dissident candidates are seeking election to the board.

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Independent Board Chair Proposals Get Mixed Reception

By Thaddeus C. Kopinski, Staff Writer

U.S. investors made limited progress in their efforts to separate the functions of board chairs and CEOs. With 20 of the 26 companies reporting results, shareholder support averaged some 30 percent. Not a single proposal got a majority vote.

Independent board chairs, a long-accepted practice in the United Kingdom, remain controversial in the United States. Just 27 percent of the S&P 500 companies have separated CEO/chair roles, according to ISS Corporate Governance Quotient data. Most (67 percent) of the S&P 500 have combined CEO/chair roles, but those companies have appointed a lead director. Another 6 percent have combined CEO/chair roles without a lead director.

The **New York Stock Exchange** now requires corporations to appoint an independent director to preside at meetings of non-executive directors, but many advocates, such as the **AFL-CIO** and the **Council of Institutional Investors**, argue that companies should go further and appoint independent chairmen with real authority.

In January, the **Walt Disney** Co. agreed to separate permanently the duties of chairman and CEO. The company acted in response to a shareholder proposal by the **Connecticut Retirement Plans and Trust Funds**. Disney CEO Michael Eisner stepped down as chairman in 2004 after institutional investors mustered a 45 percent "withhold" vote against him.

In March, **Fannie Mae** agreed to permanently split the two positions. Former CEO and Chairman Franklin Raines was forced out last year after federal regulators concluded that the company violated accounting rules for its hedges on its mortgage portfolio.

Even Without Vote-No Campaigns, Withhold Votes Mount Up

By Ted Allen, Director of Publications

While "withhold" votes received less media attention this year, investors continued to shun directors who ignore majority shareholder votes on board declassification and other issues.

Although unions and public pension funds did not organize high profile "vote no" campaigns, like they did in 2004 at Disney and Safeway, investors did use this symbolic mechanism to successfully press for change at smaller companies.

Most U.S. companies still have a plurality election standard. Unless there's a proxy fight, directors will run unopposed and can win re-election even if 99 percent of investors withhold their votes. Even though these withheld votes won't affect the outcome, investors still are using this "no confidence" mechanism to express their views.

At **Career Education** Corp., investor Steve Bostic, who owns a 1 percent stake, led a shareholder revolt that netted a 69 percent withhold vote (of votes cast) against three directors. That withhold percentage appears to be the highest ever recorded, exceeding the 61 percent vote against directors at **Federated Department Stores** in 2004. Career Education has been plagued by a series of lawsuits and is under investigation by the Securities and Exchange Commission and the Justice Department.

The **International Brotherhood of Teamsters** led a "vote no" campaign against **Central Freight Lines** Chairman Jerry Moyes, objecting to his business dealings with the company. At the company's annual meeting, Moyes stepped down "to focus on other commitments," the company said.

In May, hedge funds helped rally a 28 percent withhold vote against **MCI** Inc. CEO Michael Capellas to protest the board's decision to accept a takeover offer from **Verizon Communications**.

At **Alaska Air Group** Inc., director Byron Mallott got a 42 percent withhold vote, while three others got 34 percent withhold votes. The board failed to heed 2004 investor proposals that won majority support on rescinding supermajority vote requirements and on requiring shareholder approval of poison pills.

Most of the other noteworthy withhold votes during the early 2005 meetings were against boards that failed to implement investor proposals. For instance, directors at **Costco Wholesale** Corp., **VF** Corp., **Sempra Energy** and **Stanley Works** received withhold votes that exceeded 20 percent after ignoring board declassification proposals. (Results from other companies were not available because most firms wait until their next quarterly filing before reporting withhold votes.)

At **Monsanto** Co., two directors received withhold votes of about 24 percent after ignoring a shareholder resolution calling for an investor vote on the company's poison pill. At **McGraw-Hill** Cos., four directors received a 38 percent withhold vote after failing to implement a similar proposal, according to investors. At **Calgon Carbon** Corp., two directors received 28 percent withhold votes after the company adopted a poison pill without seeking shareholder approval.

Directors' Dealings Inspire Concern

Investors also withheld support from directors who sit on key committees but do not meet the independence standards of ISS and the **Council of Institutional Investors**. In most of these cases, these "affiliated outsiders" have significant business dealings or related-party transactions with the company that could undermine their independence.

Perhaps the most famous example is financier Warren Buffett, who sits on the board at **Coca-Cola** Co. Again this year, ISS called for Buffett to step down from the audit committee (but remain on the board), citing the $185 million in transactions between Coca-Cola and Buffett's **Berkshire-Hathaway** Inc. subsidiaries in 2004. At Coca-Cola's meeting, Buffett received a 17 percent withhold vote, up from 14 percent in 2004.

Another affiliated outsider, **Sanmina-SCI** director Mario Rosati, received a 44 percent withhold vote. He is a partner in a law firm that provides legal services to the company. Other examples of affiliated outsiders who received significant withhold votes include Duane Nelles (34 percent) at **Qualcomm** Inc. and Laurence Harris (34 percent) at MCI.

At **Dow Jones** & Co., director Vernon Jordan, who sits on more than six corporate boards, received a 32 percent withhold vote.

Executive Compensation Concerns

Executive pay concerns also led investors to withhold their votes from compensation committee members this year. However, preliminary season results indicate that these directors generally received fewer withhold votes than board members who ignored majority votes on shareholder resolutions.

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ISS has a pay-for-performance policy that compares increases in the CEO's total direct compensation with the company's short- and long-term performance. At those companies with CEO pay increases and negative one- and three-year total shareholder returns, ISS will consider recommending that investors withhold support from compensation committee members. (For more on this policy, see a separate article later in this report.)

This season, compensation committee members on the boards at least eight companies have received no-confidence votes that exceed 10 percent. At **Cendant** Corp., three compensation committee members received withhold votes ranging from 24 to 28 percent. According to *USA Today*, CEO Henry Silverman's 2004 salary ranked first among the 225 largest U.S. companies, while Cendant's performance has lagged its peers and other S&P 500 firms.

At **Family Dollar Stores** Inc., three compensation committee members received withhold votes ranging from 20 to 26 percent. The CEO's pay increased by 30 percent in 2004, while total shareholder returns have lagged the company's peers, falling by 33 percent in the past year and 3 percent over three years.

Other withhold votes that were influenced by executive pay concerns include three directors at Sanmina-SCI (about 20 percent), three directors at **Jabil Circuit** (18 percent), three directors at **Morgan Stanley** (14 percent), and two directors at **E.I. Lilly** & Co. (10 percent).

At **Gillette** Co., it appears that at least one director received a 17 percent withhold vote. Two compensation committee members were among the four directors on the ballot; the company reported that all four received at least an 83 percent vote, without providing the votes per director. The board has been criticized for agreeing to a takeover by **Procter & Gamble** Co., which would trigger generous change-in-control payments to Gillette's CEO.

At **Yahoo!** Inc., three compensation committee members received withhold votes ranging from 17 to 18 percent. CEO Terry Semel was awarded a compensation package that included a bonus option to purchase 1.8 million company shares and an annual-review option to buy four million shares in March 2004, followed by a fully vested option to purchase 1.2 million shares.

ISS Issues Fewer Withhold Recommendations

Once again this season, ISS has issued fewer withhold recommendations against directors at U.S. companies. Of the 27,124 directors voted on this year to date, ISS issued withhold recommendations against 4,667 directors, or 17 percent of the total. In 2004, ISS had withhold recommendations against 6,878 directors, or 20 percent of the 33,731 directors on the ballot. The year before, ISS recommended withhold votes against 8,574 directors, or 25 percent of the 33,924 directors up for election.

This trend is also evident if one considers the number of companies where ISS recommended a withhold vote against at least one director. This year, ISS has withheld against at least one director at 1,909 companies, or 29 percent of the 5,068 meetings so far. Last year, that figure was 32 percent; in 2003, it was 38 percent.

Shareholders Shift Tactics on Executive Compensation

By Thaddeus C. Kopinski, Staff Writer

This season, institutional investors have shifted from filing generic resolutions that seek to review or limit executive compensation to a more sophisticated approach with proposals calling for performance-based stock grants or options and "claw-back" provisions. Meanwhile, there is still strong investor support for expensing stock options, even though U.S. regulators have moved to require the practice. In addition, proposals to require severance agreements, or "golden parachutes," to be subject to shareholder approval have done well this year.

Thirty-eight performance-based compensation proposals appeared on company ballots this year, almost five times the number in 2004, according to ISS data. At the same time, shareholder resolutions seeking caps or reviews of executive pay fell from 63 to 13. Likewise, proposals seeking to limit or prohibit awards to executives fell from 39 to five this year.

Despite the jump in performance compensation proposals, results have fallen short of majority support. Most of these proposals have been backed by about 30 to 35 percent of votes cast. Notable exceptions include **Textron** and **Lucent Technologies**, where the issue drew 48 percent votes.

"While we have not seen a decline in executive pay packages, the form has definitely changed--away from stock options to performance-based long-term share awards," said Brandon Rees of the **AFL-CIO**'s Office of Investment. Stock options as a share of the average executive pay package have declined from 69 percent in 2001 to some 31 percent this year, according to Rees.

A recent survey by compensation consultant **Pearl Meyer & Partners** of 88 institutional investors with a median $38 billion in assets under management found most respondents believed that CEOs of big U.S. companies were overpaid.

"The survey indicates that money managers are highly skeptical of the rationale behind some key long-term compensation practices," Pearl Meyer said in a statement. Some 65 percent of respondents "rate shareholder returns as the first or second most important factor in setting CEO bonus and long-term incentive payments," followed by 53 percent who cited return on capital, according to the survey.

Emergence of Claw-Back Provisions

Another indicator of a more targeted approach by investors to compensation is the filing of more claw-back proposals this year. The average level of support was more than 30 percent at the four annual meetings that had such a proposal.

The proposals called for the board to adopt a policy whereby, in the event of a restatement of financial results, the board will review all performance-based bonuses and other awards that were made to senior executives, and recoup that compensation to the extent that these performance targets were not achieved. In every case, management has countered with arguments that the proposal would be too far-reaching because it would apply even to restatement situations that were not caused by misconduct.

Interest Continues in Options Expensing

Shareholder proposals calling for the expensing of stock options for executives and employees continued to appear on company ballots this season despite the fact that regulators have moved to require companies to treat options as an expense against earnings.

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In December, the **Financial Accounting Standards Board** directed public companies to start expensing in the first fiscal quarter after June 15. In April, the Securities and Exchange Commission gave public companies an extension until the start of the next fiscal year before they have to start expensing options. Some institutional investors fear that Congress or Rep. Christopher Cox, who has been nominated as SEC chairman, will intervene to thwart or further delay the rule.

Golden Parachutes

This season, investors have continued to support resolutions seeking shareholder approval of future golden parachute arrangements that exceed Internal Revenue Service limits.

With results available for more than half of the two dozen companies where the issue was on the agenda, investor support has averaged 56 percent. Such proposals received 61 percent support at **Lucent Technologies** Inc., 60 percent at **Occidental Petroleum** Corp. and **Mattel** Inc., 58 percent at **Edison International**, 56 percent at **ChevronTexaco** and the **Home Depot** Inc., 55 percent at **PG&E** Corp. and **Hilton Hotels** Corp., 54 percent at **Waste Management** Inc., and 53 percent at **Kohl's** Corp. and **Albertson's** Inc. The lowest was posted at **General Motors** Corp., with 16 percent.

In response to this interest, more companies--including **Corning**, **CSX**, **Delta Air Lines**, **Verizon Communications**, **Norfolk Southern** Corp. and **McKesson** Corp.--have agreed to seek shareholder approval for future parachute payments that exceed IRS standards, *Compliance Week* reported.

Improving Executive Compensation Disclosure

By Valerie Ho and Sandra Sussman, Senior Compensation Analysts

So far this proxy season, ISS has scrutinized the executive compensation practices of about 162 U.S. companies under its pay-for-performance policy. After comparing the companies' performance with their peers and reviewing their compensation disclosure efforts, ISS issued "withhold" vote recommendations against compensation committee members at 56 companies.

Earlier this year, ISS updated its pay-for-performance policy to allow companies the opportunity to provide specific public disclosure that demonstrates enhanced transparency and a commitment to performance-based compensation.

The additional disclosure must address in detail all components of the CEO's compensation (including dollar amounts of salary, bonus and other incentive payments and perks; qualitative and quantitative performance criteria for short- and long-term incentive pay; projected payments under retirement programs and other termination scenarios; etc.) and effectively commit the compensation committee to improving its own performance in fulfilling its fiduciary duties in connection with CEO pay.

ISS adopted its pay-for-performance policy in 2004 in response to investor concerns about the disparity between rising CEO pay and companies' poor stock performance. Under that policy, ISS examines CEO pay relative to his/her company's total shareholder return. Excessive pay remains a pressing concern for many investors, as evidenced by the investor lawsuits against directors at **Walt Disney** Co., **Cendant** Corp. and other companies.

A company with negative stock price performance over the past one and three fiscal years coupled with an increase in the CEO's total compensation generally triggers closer scrutiny by ISS.

Where the pay-for-performance policy is triggered, ISS looks at a company's sustained negative stock price performance relative to both an industry peer and a broad index to ensure that the company truly underperformed for an extended period. ISS also examines the compensation committee report to better understand the underlying rationale for the increase in the CEO's compensation. Where the compensation committee report lacks sufficient disclosure to justify a CEO's pay increase in light of the company's negative total shareholder returns, ISS recommends that votes be withheld from any compensation committee members up for election. Where disclosure in the compensation committee report was such that one could conclude that a CEO's pay was reasonably determined or tied to specific performance measures, ISS recommends votes "for" the committee members.

Transparent disclosure is critical for shareholders to understand both the mechanics and rationale behind CEO pay, and can minimize any surprises, e.g., Dick Grasso's deferred compensation package at the **New York Stock Exchange**.

The increase in CEO compensation often is driven by long-term incentives or stock-based compensation like time-based restricted stock or standard stock options. During the 1980s, stock-based compensation was less frequent, occurring once every three to five years. In the past decade, long-term incentive compensation has become an annual affair, blurring the lines between short-term incentive compensation, such as cash bonuses, and long-term compensation. Some companies have argued that the determination of long-term incentive compensation is the same as short-term compensation, i.e., based on a company's past performance, while some other companies use long-term compensation to attract and retain executive talent. The purpose of long-term incentive compensation differs among companies and therefore ISS examines compensation committee reports more closely to discern the link between pay and performance.

What is "Sufficient Disclosure"?

Identifying "sufficient" disclosure can perhaps best be accomplished by discussing disclosure that is insufficient. Generally, insufficient disclosure relies solely upon boilerplate generalities to justify executive compensation, using words and/or phrases such as:

- Attract and retain talent
- Median compensation levels at peer group companies
- Industry benchmark
- Competitive pay levels at similarly-situated companies
- Align executives' interests with those of shareholders
- Level of responsibility, position in the company
- Past and anticipated future contribution to influence long-term growth and profitability of a company
- Past performance
- Pre-established performance goals
- Discretionary criteria

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Such language would be acceptable if, in the spirit of transparency, the compensation committee report went on to discuss the specifics, such as:

- On what basis peer group companies are chosen (companies should not "cherry pick" companies based on CEO pay)
- What the peer group companies are
- The number of peer group companies (small sample size may result in inconsistent or unrealistic statistics)
- The range of compensation and what percentile of that range the company would like to achieve and how it is tied to the company's performance
- Specific expectations for individual and company performance
- Specific performance goals and targets and how actual performance compared
- If discretionary measures are used, what such measures are in any given year
- How equity values are determined and that equity grants made early in the year relate to the prior year's performance (if that is, in fact, the case)

Transparent Disclosure--More Really is More

One excellent example of transparent disclosure is **Libbey** Inc.'s 2005 compensation committee report. In an easy-to-read Q&A format, the report covers the company's executive compensation policies, the components of executive compensation, how base salaries are determined, how performance-based compensation is determined and how CEO compensation is determined.

In addition to providing more detailed information about the annual cash incentive program, this year's report includes a new section entitled "What Actions Has the Compensation Committee Taken to Ensure that Executive Compensation is Reasonable?" This section notes that the compensation committee has reviewed tally sheets "affixing dollar amounts to all components of the named executive officers' 2004 compensation, including salary, bonus, equity and long-term incentive compensation, realized and unrealized gains on stock option grants, the dollar value to the respective executives and cost to the company of perquisites and other personal benefits, and the actual projected payout obligations under the company's retirement plans, including the company's Supplemental Executive Retirement Plan (SERP) and executive savings plan, and under several potential severance and change-in-control scenarios." The committee also discloses the amounts of each component to which the CEO would be entitled under three scenarios: termination for good reason or without cause, termination for cause and a change in control.

Another example of transparent disclosure is **Altera** Corp. Although the company has sustained negative stock performance for the one- and three-year time periods, it outperformed its industry peer group (semiconductors and semiconductor equipment). The company provided enhanced disclosure on CEO pay and committed to future pay-for-performance and performance-based equity awards.

Under the company's cash bonus program, the criteria for payouts will be based on (1) annual growth in revenue and net income as a percentage of revenue above a specified threshold, and (2) performance against individual goals. Maximum payout is 200 percent of base salary for the CEO. Under the long-term equity compensation program, the committee decided to grant a substantial portion of future equity awards to executive officers, including the CEO, contingent upon the company's attainment of a pre-established financial target. Fifty percent of the shares that may be awarded to these executives in 2006 will be contingent on the company generating free cash flow as a percentage of total assets in 2005 that is greater than 15 percent. The maximum number of shares that may be awarded to any executive in 2006 will be 700,000. If the performance criteria are not met in 2005, then the maximum number of shares that any executive may be awarded in 2006 will be 350,000. Termination payments to the CEO on three different termination scenarios (for cause or voluntary, other than for cause, and change in control) were outlined in the proxy statement.

Nobody Wins With Vague Disclosure

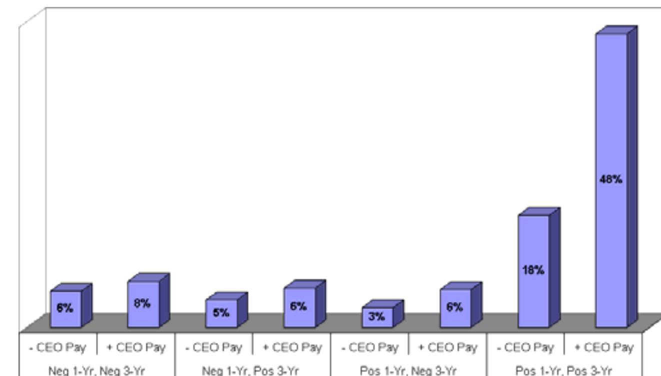
Many companies still fail to provide sufficient detail about executive compensation. For example, one company's compensation committee report states that the CEO's grants in 2004 were in recognition of past and recent contributions and to continue the process of increasing the CEO's equity stake in the company to a level at or near that of CEOs at comparable companies. But, the report does not specify what portion of the grants were in recognition of the CEO's contributions or explain what those contributions were, nor does the report attempt to explain how the committee derived the option grant values, or define the "appropriate" level of equity in the company it would like the CEO (and other executives) to achieve.

This vague language serves only to raise more questions than it answers, leaving shareholders to draw their own, possibly misguided, conclusions about the CEO's pay. ISS believes that companies and their shareholders will always benefit from clear, transparent disclosure.

Pay-for-Performance Withhold Recommendations

ISS applies its pay-for-performance policy by considering various factors. A company with sustained negative stock performance coupled with an increase in CEO pay does not automatically result in a withhold recommendations. Of the 2,153 annual shareholder meetings of the Russell 3000 companies scheduled between this January and June, 48 percent of the companies had positive stock performance over the one- and three-year period and approved an increase in CEO's pay (See Chart 3).

Chart 3: Snapshot of CEO Pay and Company Stock Performance
Russell 3000 Universe (N=2, 153)
Jan 1 – Jun 30 Annual Shareholder Meetings



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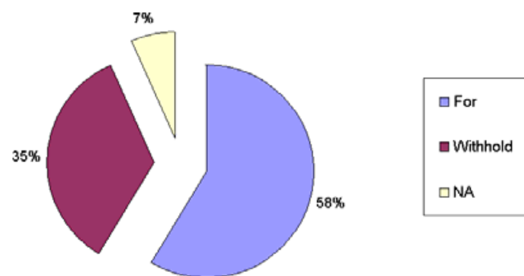
Approximately 8 percent (or 162 companies) triggered the initial screening of ISS' pay-for-performance policy. Of these companies, 58 percent did not garner unfavorable vote recommendations on the compensation committee members with 16 percent being S&P 500 companies. Thirty-five percent of companies received withhold vote recommendations with 18 percent being S&P 500 companies (See Chart 4). The policy could not be applied to 7 percent of companies since no compensation committee members were up for annual election. Overall, 56 companies this year received withhold vote recommendations on compensation committee members.

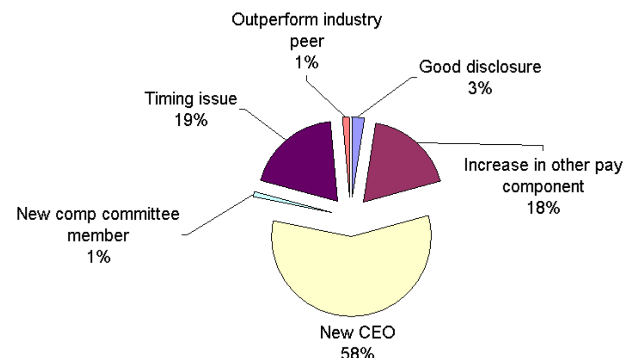
Chart 4: Vote recommendations on Disparity Between CEO Pay and Performance
N = 162 Companies
Jan 1 – Jun 30 Annual Shareholder Meetings



Of the total companies that did not receive unfavorable vote recommendations, the following reasons were captured:

- Outperform industry peer group, e.g., Altera
- Good disclosure, e.g., Libbey
- New compensation committee
- New CEO
- Timing of equity grant, e.g., fiscal 2004 option grant was awarded based on 2003 company and/or individual performance
- Increase in other pay component such as cash bonus where the performance measures were disclosed

Chart 5: Reasons For Refraining from Withholds



Where companies disclose that the most recent fiscal year (e.g. 2004) equity grant is solely based on previous year's (e.g., 2003) corporate or individual performance, ISS will generally adjust the CEO's most recent complete fiscal year (e.g., 2004) total direct compensation. These companies usually award long-term incentives at the same time each year, and usually do so early in the fiscal year. Such adjustment is usually a credit on the 2004 equity grant and a debit on the 2005 equity award as disclosed in Form 4 filings.

ISS recognizes that such adjustment may be inconsistent with annual executive pay surveys or proxy compensation analyses conducted and published by executive compensation consulting firms. These firms typically calculate CEO pay by summing base salary, actual bonus, annualized LTIPs and long-term incentives as disclosed for the most complete fiscal year. No adjustment is made even if a company discloses that the 2004 equity grant is based on 2003 corporate and/or individual performance. The competitive pay data are then furnished to compensation committee members so that they can make recommendations on CEO compensation to the board. ISS is concerned that the competitive pay data used may be flawed since the appropriate adjustments likely have not been made. To avoid this issue, companies may want to grant equity awards at the end of the fiscal year to reflect current year's performance.

Many companies have taken positive steps to provide more transparent and meaningful disclosure to shareholders. Shareholder activism and executive compensation litigation have compelled companies to meet the spirit of proxy disclosure. While this practice is still not the norm across all companies, more companies are taking action to avoid using boilerplate language in the executive compensation report. Because of increased proxy disclosure, ISS ended up withholding from fewer compensation committee members than it might have otherwise. This season's statistics show that the ISS pay-for-performance policy resulted in withhold vote recommendations from compensation committee members at about 35 percent of the 162 companies that triggered the policy. Still, more work needs to be done in terms of awarding truly performance-based equity awards rather than tenured or time-based awards to senior management.

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Environmental, Labor Issues Top Social Investing Priorities

By Thaddeus C. Kopinski, Staff Writer

Environmental management issues, including proposals on greenhouse gas (GHG) emissions and renewable energy, led this season's list of social investing priorities with 64 proposals. Labor standards (63 proposals) were next, followed by diversity and equality issues (46 proposals). Together, these accounted for about 63 percent of all social shareholder proposals filed this season, according to ISS data compiled in April.

The large number of environmental proposals was due in part to the Kyoto Protocol to the United Nations Framework Convention on Climate Change, which went into effect in February following Russia's ratification of the treaty. Countries that committed to the Kyoto Protocol have agreed to reduce overall emissions of carbon dioxide and other greenhouse gases by an average of 5.2 percent from 1990 levels.

While the United States has not ratified the treaty, U.S. companies will have to comply with new climate change regulations in the 128 countries that have done so if they do business in them. More shareholder proposals can be anticipated in the coming years as the implementation challenges of the protocol become clearer.

This season, of the 64 environmental proposals, there were 32 on GHG emissions and climate change issues. At **Exxon Mobil** Corp., a proposal calling on the company to report on the financial implications of Kyoto compliance won 28 percent of votes cast.

At 23 companies, shareholders voted on proposals seeking sustainability reports, including eight requesting that companies follow Global Reporting Initiative (GRI) guidelines.

Once again, environmental proposals prompted constructive dialogue. A GHG resolution at **Ford Motor** Co. was withdrawn by **Christian Brothers Investment Services**. Ford, the second-largest U.S. automaker, agreed in March to issue a first-of-its-kind report on the business implications of reducing GHG emissions. **J.P. Morgan Chase** agreed to shareholder demands to establish project financing guidelines that consider potential environmental and social impacts, including GHG emissions. Other firms that reached similar agreements with investors include **ChevronTexaco** Corp. and **Unocal** Corp.

Labor and Human Rights

Sixty-three proposals were filed concerning international labor standards, human rights, workplace codes of conduct, outsourcing, and living wages. Of those, 27 proposals urged adoption of International Labor Organization standards and other global labor and human rights standards.

Some 18 proposals called on companies to address overseas outsourcing and job loss within the U.S. (up from two a year ago), and another 11 sought to have companies address the global HIV/AIDS crisis and other potential health pandemics, including access to affordable drugs. Other proposals urged companies adopt a set of corporate standards or prepare a report that is specific to a particular country or industry, such as labor standards in China (six proposals), Northern Ireland (five), or the maquiladora operations, usually assembly plants on the Mexican side of the border with the U.S.--with this generation of proposal focusing on employees' safety from crime.

There were 46 proposals on diversity and equality issues this season, compared to just 13 that reached the ballot in 2004. Board diversity was the subject of 13 proposals, up from five a year ago.

Sexual orientation proposals were filed at 22 companies, compared to just three proposals reaching the ballot last year. Investors withdrew proposals at **Omnicare** Inc., **C.H Robinson Worldwide** Inc. and **Alltel** Corp. after the companies adopted non-discrimination policies.

International Developments: Canada & Europe

By Thaddeus C. Kopinski, Staff Writer

The following are some of the key corporate governance developments in Canada and Europe during the 2005 proxy season.

In March, the **Canadian Accounting Standards Board** (AcSB) released for comment a strategic plan to eliminate Canadian GAAP as the accounting standard for Canadian public companies over a five-year period beginning in 2006. The AcSB has decided to converge Canadian GAAP with the International Financial Reporting Standards (IFRS) and has posted a draft paper outlining the strategic plan.

To achieve convergence, the AcSB will amend or replace individual Canadian standards to conform to existing and new IFRS, and will work with both the **International Accounting Standards Board** (IASB) and the **U.S. Financial Accounting Standards Board** (FASB) to ensure that the Canadian perspective is taken into account. Once the convergence is complete, the AcSB will no longer make final decisions on most matters affecting the technical content and timing of implementation of standards applied in Canada. The decision reflects a general trend to continue with a principles-based approach to accounting rules that characterizes both Canadian GAAP and IFRS. Comments can be submitted to the AcSB until July 31.

Improving Executive Compensation Disclosure in Canada

The **Canadian Securities Administrators** has released guidelines to help companies with disclosure of their executive compensation practices, specifically targeting retirement benefits. These guidelines are voluntary and go above and beyond the disclosure currently required. The recommendations seek to help issuers identify and incorporate the most pertinent and useful information for investors within their proxy materials. Specifically, the new guidelines suggest disclosure that includes: (i) the total retirement benefit liability of the issuer associated with each executive, (ii) the total service costs in respect of the plan during the past year, and (iii) the estimated annual benefits payable on retirement to specific executives.

European Union Seeks More Comment on Governance Directive

In May, the European Union's **Internal Market General Directorate** launched a second public consultation round on its "Action Plan on Modernizing Company Law and Enhancing Corporate Governance in the EU," which seeks to enhance shareholder rights to vote and participate in company meetings. The deadline for comments was July 15.

In large markets such as the United Kingdom, Spain, Italy, France or Germany, more than 30 percent of the share capital of listed companies typically is held by non-resident shareholders. In other countries such as Luxemburg, Latvia, Hungary, Belgium or the Netherlands, this proportion may reach 50 percent, and in some cases as much as 70 to 80 percent, the EU notes. Many national laws governing shareholder meetings and voting have not been updated to reflect the modernization and computerization of share holdings and are ill-suited to modern investing and cross-border investment, the report notes. The proposed measure is opposed by European business groups.

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In the first round of consultations, a majority of respondents urged European regulators to concentrate on high-level principles and only impose minimum standards, rather that attempt to harmonize detailed aspects of member states' laws. Individual countries should be given sufficient flexibility in implementing these principles and choose the best option for their systems, the report noted.

European Parliament Approves Cross-Border Merger Directive
Also in May, the **European Parliament** approved an amended draft directive aimed at facilitating cross-border mergers, clearing the way for early adoption of a measure for which business has been waiting more than two decades.

The merger directive is a key part of the EU's 2003 plan to modernize company laws. The proposal applies to legal mergers of the share-exchange type rather than to the (far more common) acquisition by one company of another, which becomes a subsidiary. At present, cross-border transactions of this sort are illegal in Germany and numerous other member states, and difficult elsewhere, usually entailing an expensive winding-up of the company or companies being absorbed. The proposal is aimed in particular at smaller companies for which the 2001 European Company Statute does not provide an appropriate solution.

New EU Stock-Option Expense Rule
In February, the European Union, in the final step in the regulatory process, approved a regulation requiring the expensing of stock options. The EU's 25 member states approved the rule on Dec. 20. Companies will have until Jan. 1, 2006 to comply.

The rule, modeled after International Financial Reporting Standard No. 2, requires that companies reflect in their income statements the effects of share-based payment transactions, including expenses associated with granting stock options to management and employees. Under the new standard, companies must subtract the expense of options from earnings, which could significantly reduce their profits. In the past, companies were only required to put those costs in footnotes to financial statements rather than on income statements.

The options rule is among a so-called stable platform of IFRS accounting standards that the almost 8,000 listed European companies are moving to adopt. The IFRS rules will enhance transparency and make it more difficult for companies to hide fraud, as **Parmalat Finanziaria** Spa was able to do for years under Italy's less stringent disclosure requirements.

IFRS 2 does not specify which valuation models for stock options should be used. As a principle-based standard, it only describes the factors that should be at least taken into account when estimating the *fair value* of share-based payments, according to the EU press release. The commission will monitor the future effects of IFRS 2 on European companies and review the applicability of the standard by July 2007 at the latest.

U.K. Companies Makes Progress on Electronic Voting
With the United Kingdom widely viewed as a global leader in corporate governance, developments on this issue in that country impact not only the domestic market. In January, Paul Myners, interim chairman of retailer **Marks & Spencer** and a leading corporate governance advocate, published a progress report to the **Shareholder Voting Working Group** on the impediments to voting U.K. shares--one year after his initial report, which outlined a comprehensive action program to remove voting impediments at U.K. companies. The report concluded that electronic voting was the key to a more efficient voting system.

The updated report notes that there is a high degree of confidence that the barrier has been broken. Every FTSE 100 company now allows electronic voting or is taking steps to do so. At the end of 2004, 88 of the companies in the FTSE 100 facilitated CREST's electronic voting service, compared with 47 in 2003, and the remaining 12 have indicated that they will take the necessary steps this year. Following on from the publication of Myners' report, the **Financial Reporting Council** has encouraged listed companies to offer shareholders the opportunity to withhold their votes, rather than simply voting for or against motions at annual general meetings.

Concern Over Stock Lending
In May, Myners also weighed in on another governance issue--the borrowing of shares by some investors to boost their voting rights and exert greater influence over management than their investment would otherwise allow. Technically the practice is legal, but there is growing opposition to it. Myners said stock lending distorted companies' ability to communicate with their shareholders.

The report cited one example where a company saw the proportion of capital held by its 20 investors fall from 46 to 36 percent in the run-up to the annual meeting. "Borrowing shares solely for the purpose of acquiring the vote is inappropriate," Myers said in his report. "Stock lending has become increasingly significant and has become an issue for companies."

The **International Corporate Governance Network** discussed its proposed code of best practices on this issue at its annual meeting in July. The German government is also considering imposing reporting requirements on stock lending by hedge funds.

New U.K. Pension Plan Rule
Starting in April 2006, there will be a £1.5 million cap on the pensions that U.K. employees can accrue over their working lives--a limit many company directors will comfortably exceed. In anticipation of this, the **National Association of Pension Funds** issued a policy statement in January that included a note that companies should explain clearly during the 2005 reporting season what their response will be in pension provisions for executives, particularly executive directors.

Belgian Governance Code Takes Effect
A new Belgian Corporate Governance Code entered into force in January. In response to companies' concerns about measuring compliance, the drafters created a three-part code that includes principles, provisions and guidelines. The code was drafted by the **Belgian Corporate Governance Committee**, which was created last year by the **Banking, Finance and Insurance Commission**, the **Federation of Enterprises in Belgium**, and **Euronext Brussels**.

The code focuses on the communication of information to shareholders in connection with general meetings as well as on underlining shareholders' equal rights of access in that respect. It encourages the use of electronic means for communication and lowers the required ownership level to 5 percent for the submission of proposals at general shareholders' meeting; it also requires that vote results and minutes be made available as soon as possible after the meeting.

Since the code entered into force, companies must include corporate governance as an agenda item for consideration at their annual meetings and address the issue in their annual reports. By Jan. 1, 2006, listed companies must release a Corporate Governance Charter that outlines their corporate governance structure and policies. In their 2005 annual reports, listed companies will be expected to devote a specific chapter to corporate governance, describing their governance practices during that year and including explanations, where applicable, on deviations from the code.

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Finnish Parliament Raises Limit on Share Repurchases
In March, the Finnish parliament amended the Companies Act, raising the maximum limit on share repurchases from five to 10 percent of outstanding share capital. During the 2005 proxy season, many Finnish companies asked shareholders to approve share repurchases up to 10 percent of the issued share capital, subject to parliamentary approval of the amendment. The new law is in line with EU regulations.

In addition, the **Finnish Ministry of Trade and Industry** is asking shareholders to approve amendments to the articles of association for state-owned companies and state-associated companies that would set an upper age limit at 68 years at the time of appointment of members of boards of directors and supervisory boards. This, according to the ministry, corresponds to the retiring age under the overall pension reform, which entered into force in 2005.

The ministry is also seeking to change the nomination procedure of candidates to the boards of publicly listed state-owned companies and the state's associated companies. It proposed that representatives of the few major shareholders and the board chairman, as an expert member, should, in general, be appointed to a nomination (appointment) committee. Incumbent board members, other than the chairman, would not be eligible to serve on the nominating committee.

French Class-Action Initiative Stalls
In January, President Jacques Chirac proposed that France adopt legislation to permit U.S. style class-action lawsuits, as a part of an initiative to strengthen consumer rights. Chirac's original proposal did not include securities cases, but shareholder advocates, including the **French Minority Shareholder Association** (ADAM), have urged the government to consider that.

Under a 1994 law, shareholders have the right to join forces in associations to make their voices heard and possibly sue management. A minority shareholder can sue a majority shareholder, but the company collects any damages in such a suit. For instance, **Orange** minority shareholders challenged the fairness of the price offered in a buyout by majority shareholder **France Telecom**.

French business groups argue that any class suits should be limited to only those plaintiffs who sign up to join the class. In the U.S., securities class lawsuits, once certified by a judge, include all investors, except those who opt out. So far, there has been little progress on Chirac's proposal.

New Vote Disclosure Rules for Fund Managers in France
In June, French stock market regulator, the ***Autorite des Marches Financiers*** (AMF), issued new rules requiring fund managers to declare how they voted their shares of companies, both foreign and domestic, in which they invest. The voting record must be kept open for consultation either on fund managers' websites or at their headquarters. Fund managers should also explain to clients what the outcome of any resolution at company meetings has been.

The new disclosure rules come after the introduction of a law last year requiring managers of French mutual funds to vote their shares. If they do not vote, they must explain why to the funds' unit holders. At the beginning of the year, the AMF issued a report examining 118 listed companies' annual reports, and also conducted interviews with their preparers and auditors. The study focused on the two main elements of the 2003 *loi sur la securite financiere* (LSF): corporate governance and internal controls.

While the AMF noted considerable progress made by companies under the LSF requirements, the regulator called on companies to provide more information to the market on the function of the board of directors and committees, as well as the work which they do and how they are evaluated.

The AMF also called for an industry standard for internal control evaluation to help companies better examine their risk processes.

New French Rules on Golden Parachutes?
In April, Finance Minister Thierry Breton criticized extravagant severance packages for chief executives and promised to give shareholders a greater say over these "golden parachutes." Breton has also announced tax incentives to increase profit-sharing bonuses for employees.

Breton's comments followed the public uproar over a retirement package worth up to 38 million Euros ($26 million), awarded to Daniel Bernard, former chief executive of the **Carrefour** retail group. **Vivendi Universal** CEO Jean-Rene Fourtou and Louis Schweitzer, head of **Renault**, France's second biggest car manufacturer, both stepped down amid severance pay controversies.

Germany Considers New Compensation Disclosure Law
In early July, the German Parliament enacted a law that will require public companies to disclose the salaries of their most senior executives in their 2006 annual reports, or face fines in excess of $60,000 for each board member. A company can opt out of the law if it gets a two-thirds vote (of votes cast) from shareholders. The measure brings German law in line with legislation in the U.S. and the U.K.

While the law requires disclosure of salaries and bonuses, it does not mandate a detailed breakdown of stock options, their current value, or a calculation of how they might appreciate, as is required in the U.S. While the German law does mandate severance payments to be disclosed, it does not require companies to explain what conditions, like a corporate takeover, could trigger such a payout.

German Chancellor Gerhard Schroeder has also called for international minimum standards on hedge fund activities, including the lending of shares.

German Lawmakers Consider Class Action Legislation
German lawmakers are considering draft legislation that would allow the aggregation of securities claims by multiple investors. The proposed legislation would not create U.S.-style class actions, but it would lower the obstacles for investors to claim damages. Under the draft law, investors could request a model proceeding to resolve common issues of fact or law concerning a company's disclosure of allegedly misleading information. A court would select a lead plaintiff and then make legal and factual determinations that would be binding on all potential plaintiffs, including those who did not join the model proceeding. Germany does not permit contingency fees, and the draft law would not provide any additional incentives to law firms that represent investors. The fate of this legislation is uncertain with national elections scheduled later this year.

Deutsche Boerse Fallout May Spur Tighter Hedge Fund Rules
The ouster by foreign investment funds of German stock exchange **Deutsche Boerse** chief executive Werner Seifert and of Rolf Breuer, the chairman of its supervisory board, in the wake of their aborted bid for the **London Stock Exchange** (LSE) has brought calls for tighter regulatory controls. But the managers at many top German companies have few concerns. Deutsche Boerse has an internationalized investor base that makes it untypical of German companies: only seven percent of its shares were owned by German investors at the latest count. By contrast, Germans own 50 percent stakes on average in the Dax-30 blue chip companies.

The shareholders, led by the U.K.'s **Children's Investment Trust** (TCI), which owns a 7.5 percent stake in the Deutsche Boerse, and **Atticus Capital**, which owns about 5 percent, believed that the exchange had over-bid in its effort to take over the LSE and should instead hand back some of the

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funds to shareholders. Two more major shareholders--**Merrill Lynch Investment Managers** and **Fidelity Investments**--emerged to register their disapproval for the proposal, after the chairman told bankers his company's bid was only being opposed by a couple of hedge funds.

Economics minister Wolfgang Clement reacted by calling for a "thorough" review of hedge fund activities, in the highest-level political reaction, as senior politicians of the governing party publicly branded hedge funds as "locusts." Concurrently, German regulators issued a code for fund managers recommending how they should organize internal and external governance. The report focused on disclosure of information including share-voting policies.

New Governance Rules in Hungary
In March, the **Budapest Stock Exchange** adopted amended regulations to ensure orderly and transparent trading. The amendments regulate issues such as the payment of dividends on treasury shares, the content of the interim and annual reports and the listing and delisting of securities. In addition, the amendments oblige each company to submit a statement confirming its acceptance of corporate governance recommendations.

The 2005 proxy season also saw many companies changing their articles of association to comply with recent Hungarian commercial law changes. Hungary is now amending its corporate and capital market laws to harmonize them with the relevant EU legislation.

Class Action Legislation in the Netherlands
The Dutch Senate recently approved class-action legislation to allow the creation of classes for securities settlement purposes. Under that law, proposed settlements would be reviewed by the court, which would verify that the plaintiff was sufficiently representative of the class and that the proposed class would be large enough. As in the U.S., class members could opt out of a settlement. The law would also allow plaintiffs to claim damages. Only actual damages could be sought, as the Netherlands does not recognize punitive damages.

At the end of 2004, lawmakers required all listed companies to report on their compliance with the Dutch Corporate Governance Code published by the Tabaksblat Committee in 2003. Companies are required to report why they did not comply with specific provisions of the code. In January, the **Amsterdam Enterprise Chamber** ordered an investigation into events behind **Ahold**'s accounting scandal two years ago. It also ordered a probe into **Unilever**'s decision to opt for a share swap instead of returning cash to Dutch preference shareholders.

New Governance Rules Await Implementation in Italy
In March, the lower house of the Italian Parliament approved corporate governance legislation, *Legge sul Risparmio* (law on savings), which was inspired by the **Parmalat** bankruptcy. Approval by the Senate is expected soon. In April, **Consob** (the authority regulating the Italian securities market) issued final clarification of rules aimed at eliminating mandatory share blocking. However, the measures came too late to significantly affect this proxy season, as financial intermediaries continued to apply old regulations (which, among other things, prescribe a five-calendar-day blocking term as well as record date).

Under the legislation, only companies that specifically indicate their intention to maintain blocking effective within their bylaws will be able to engage in the practice. Moreover, share blocking terms have been reduced to two business days prior to the meeting--a term that corresponds to the record date applicable across the board to all issuers. By January 2006, financial intermediaries' communications to issuers will have to take place electronically, a solution that will speed up the completion of registration requirements in the future.

Revised Governance Code Takes Effect in Poland
Poland's amended corporate governance code went into effect at the beginning of this year. Public companies on the **Warsaw Stock Exchange** must report on their compliance with the code or explain reasons for non-compliance. In comparison to its 2003 predecessor, the new code significantly tightens rules on the role of auditors, procedures on changing the agenda of meetings, and the disclosure of annual meeting documentation.

Of the 238 companies listed on the Polish bourse, 97 reported full compliance with all binding provisions of the document, while nine do not fulfill any of the criteria required by the document. A new board independence rule took effect in late June, requiring that at least half of the board consist of independent directors. If one shareholder controls more than 50 percent of the voting shares, the board should include at least two independent directors, including the chair of the audit committee.

Spain: New Savings Bank Reporting Requirements
The Spanish stock market commission, the ***Comision Nacional del Mercado de Valores*** (CNMV), is reviewing new reports by the country's savings banks on their financing, salary policies, political contributions, related party transactions and other governance provisions. Those reports were to be provided to the CNMV by June 30.

Emilio Botin, chairman of **Santander Central Hispano Bank**, went on trial to face criminal charges that he inappropriately approved golden parachutes, or severance packages, for two executives who left the bank in 2001 and 2002. The charges stem from complaints from shareholders. The bank said the payments were in accordance with its bylaws and approved by its board of directors. Though the Botin family, who has run the bank for more than a century, controls less than 2 percent of the bank's shares, it has four seats on its 19-member board.

Swiss Shareholders Oppose Over-Boarding
The most noteworthy annual meeting in Switzerland this proxy season involved the **Ethos Investment Foundation**, which won 36 percent support on its proposal to block **Nestle** S.A. CEO Peter Brabeck-Letmathe from also taking the company's chairmanship. The Foundation also opposed Brabeck from becoming the vice chairman at **Credit Suisse Group.** Subsequently, Brabeck resigned as vice chairman of Credit Suisse.

Ethos argued that Brabeck had too many board memberships and responsibilities at Nestle to effectively represent shareholders. In addition to serving on the Nestle and Credit Suisse boards, Brabeck is also on the boards of **Roche Holding** AG and **L'Oreal** SA. The foundation, which represents several Swiss pension funds, also opposed the re-election of board members Thomas Bechtler and Ernst Tanner at Credit Suisse. Bechtler is chairman of **Zellweger Luwa** AG and sits on five other boards, while Tanner is CEO and chairman of **Lindt & Spruengli** AG and sits on the boards of **Swatch Group** AG and **Adecco** SA.

Russian Court Verdict Highlights Investor Concerns
Ex-**Yukos Oil** Co. CEO Mikhail Khodorovsky, and his business partner, Platon Lebedev, were found guilty of fraud and tax evasion in May and sentenced to nine years in prison. The case was widely seen in Russia and elsewhere as a politically motivated attack on an entrepreneur who built the Yukos oil conglomerate--once Russia's largest company--and who was using his wealth to gain political influence to challenge Russian president Vladimir Putin by helping to finance Russia's liberal democratic opposition.

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The controversy over Khodorovsky and Yukos--which has simmered over the past two years--has contributed to slowing economic growth in Russia and has undermined the country's credibility with both foreign and domestic investors. As the **World Bank** has noted, "the growth slowdown in the oil sector and some other parts of the economy is quite likely connected to fallout from the prolonged Yukos affair and perceptions of greater discretionary state intervention in economic affairs to the disadvantage of private business."

One encouraging step is the Russian government's recent decision to remove the limits on foreign ownership of shares of **Gazprom**, the giant state gas monopoly. Liberalization of Gazprom's share ownership would change the profile of its shareholders and bring new capital into Russia's market.

Turkey Makes Progress

Turkey has made significant strides in corporate governance in the past two years, although much still remains to be done, according to a report on corporate governance in Turkey issued in April by the **Institute of International Finance** (IIF). Noting that the prospects for integration with the European Union have been an important catalyst for change in Turkey's corporate governance practices, it nevertheless adds, "New steps are needed by the country's government and regulatory authorities to secure compliance and enforcement of essential rules and regulations."

Amendments to the Commercial Code are now being considered by parliament that may address some of these issues.

International Developments: Asia/Pacific & Latin America

By Thaddeus C. Kopinski, Staff Writer

The following are some of the key corporate governance developments in the Asia/Pacific region and Latin America during the 2005 proxy season.

Fear of hostile takeovers is the driving factor at many Japanese corporate meetings this year. This concern was driven by two developments: the impending legalization of stock-swap acquisitions of Japanese companies by foreign companies, and the partly successful unsolicited takeover of **Nippon Broadcasting System** (NBS) by **livedoor** Co. earlier this year.

Pursuant to an amendment to Japan's Commercial Code, foreign corporations will for the first time be allowed to use shares of wholly-owned Japanese subsidiaries to acquire listed Japanese companies. Although these so-called "triangular mergers" are intended to be used for friendly acquisitions, not hostile ones, fears of foreign companies sweeping in and buying up their Japanese rivals have been cited by commentators as justifying defensive measures, and were sufficient to induce politicians to delay the introduction of triangular mergers from 2005 to 2006.

At its annual meeting in March, **Pilot** Corp. became the first Japanese company to seek to amend its articles of incorporation to allow the board to select a record date for voting rights at the annual meeting different from its fiscal year-end, which is ordinarily the record date for annual meetings in Japan. This would effectively allow the board to confer voting rights on new shares issued between the fiscal year-end and the date of the annual meeting.

Progress on Japanese Commercial Code Revisions

The battle for NBS coincidentally came as Japan debated the latest round of Commercial Code revisions, and as a panel of the **Ministry of Economy, Trade & Industry** finalized its new guidelines on takeover defenses. Most companies decided to hold off on introducing poison pills this year, as the Tokyo High Court ruled against control equipment maker **Nireco** Corp., which in March became the first Japanese listed company to adopt a poison pill. However, several hundred companies took steps to lay the groundwork for poison pills by proposing to increase their authorized capital, while other companies sought to introduce classified boards, eliminate vacant board seats, and make it more difficult for shareholders to remove an incumbent director.

In addition to increasing authorized capital, a number of companies sought approval for other changes intended to make it more difficult for a hostile bidder to gain control. Another Commercial Code amendment will lower the threshold for removing a director from a two-thirds majority of votes to a simple majority. However, companies will be allowed to maintain the higher threshold if they amend their articles for this purpose. Other companies proposed to amend their articles so as to be able to introduce a modified classified board structure, although because director terms can be no more than two years in Japan, a board can have no more than two classes.

Earlier this year, **Shoei** Co. became the latest Japanese company to propose to adopt a U.S.-style board of directors, with audit, compensation, and nomination committees. Japanese law requires companies adopting a board-with-committees structure to appoint at least two outside directors, because each committee must have at least three members, a majority of whom must be outsiders.

Such companies must also appoint a board of executive officers, whose members are chosen by the board of directors, in order to separate the management execution and oversight functions. Such companies must also require all directors to stand for reelection every year. Finally, companies adopting the new board structure must abolish their board of internal statutory auditors, whose function is taken over by the audit committee.

Investment Rules Eased in China

In February, Chinese regulators issued rules allowing domestic commercial banks to set up fund-management companies. They also unveiled guidelines permitting corporate retirement funds to invest in stocks through mutual funds and both domestic and foreign insurance companies to invest directly in the stock market for the first time. Previously, insurance companies could invest only through funds.

Additionally, regulators have expanded the quotas for foreign institutional investors to buy Yuan-denominated class A shares through the so-called Qualified Foreign Institutional Investors system. This move would allow more domestic and foreign institutional investors to enter China's stock market. They also hope long-term institutional investments will inject greater stability and rationality into a market that has long been dominated by short-term speculators.

However, major problems that have deterred many individual investors--a shortage of high-quality listed companies, lack of transparency, and rampant insider trading--are also making many institutional investors cautious. Over the last few years, the market has seen a steady decline in investment and liquidity. Total market capitalization fell by 13 percent to RMB 3.7 trillion ($446.9 billion) at the end of 2004 from a year earlier, according to the **China Securities Regulatory Commission**.

In the longer term, the recent regulatory changes should open the Chinese market more to institutional investors. Analysts estimate that Beijing's approval of local insurers and of branches and joint ventures of foreign insurers could bring in potential capital totaling $7 billion.

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Governance Code Takes Effect in Hong Kong
The **Hong Kong Stock Exchange's** (SEHK) amended corporate governance code went into effect in January. These amendments echo those made to the combined code in the U.K. following the reviews conducted by Derek Higgs on the role and effectiveness of non-executive directors and Sir Robert Smith on audit committees. One provision relating to disclosure requirements about internal controls went into effect at the beginning of July.

The new code covers five aspects of corporate governance**:** directors; remuneration of directors and senior management; accountability and audit; delegation by the board; and communication with shareholders. In addition to the principles of good corporate governance**,** the code sets out two levels of recommendations--code provisions and recommended best practices.

Singapore: Scandals Spur New Board Composition Rules
In May, the **Singapore Stock Exchange** announced it will tighten corporate government measures, following a series of scandals involving public companies. The most high-profile of these involved unauthorized speculative trading on the world oil market by jet fuel trader **China Aviation Oil**, owned by the Chinese government.

One of the key amendments will be a requirement for firms to have two independent directors permanently on the board, rather than just at the time of listing as is now required. Foreign-listed firms will also be required to have at least two resident board directors who are qualified to advise management on local corporate laws. The **Monetary Authority of Singapore** is to give the final approval following the public consultation process, which ended July 1.

Efforts to Oust SK Chairman Fail in South Korea
The most controversial Korean shareholder meeting in years was the March meeting of **SK** Corp., Korea's largest oil refiner and the core company in the SK *chaebol.* The controversy stemmed from the attempt by the company's largest shareholder, **Sovereign Asset Management** (SAM), to oust the company's chairman, Chey Tae-Won. Although SAM, which owns just under 15 percent of SK Corp., repeatedly denied any intention of taking over the company, its efforts were portrayed in the Korean media, and seen by many Koreans, as a hostile takeover.

Chey, the nephew of the founder of the SK group, the most-senior executive at SK Corp. was convicted and sentenced to a three-year prison term in 2003 for accounting fraud and breach of fiduciary duties in connection with accounting problems at listed subsidiary **SK Networks** (then known as SK Global) and with Chey's trading in shares of SK Corp. and other group firms. Chey was released on bail in October 2003, after seven months in prison, and is appealing his conviction. He never resigned his seat on the board of SK Corp.--although he did step down from the board of affiliate **SK Telecom**--and he sought reelection to the board this year for the first time since the scandal broke. Chey's reappointment received the unanimous backing of the company's board of directors.

Australian Companies Make Progress
A mid-year review by the **Australian Stock Exchange** (ASX) of more than 1,000 annual reports found that more than two-thirds of Australian companies have adopted all 28 corporate governance measures recommended by the exchange. Companies are not required to adopt the recommendations, although if they do not, they must enact alternative practices. The ASX said the average adoption rate for all its recommendations was 68 percent in 2004, and was almost 85 percent among the largest 500 companies.

Some of the recommendations most readily adopted by companies included providing disclosure principally relating to director independence, board composition, charter and operation of the audit committee. Companies were also receptive to disclosing the functions to be carried out by the board exclusively and those delegated to management, the report said.

Brazil: Bovespa Launches a New Listing for Smaller Companies
In May, **Bovespa**, the Sao Paulo Stock Exchange, announced a new listing segment known as "MAIS" (*Mercado de Acoes para o Ingresso de SAs*) to help smaller companies attract investors. It allows initial public offerings with significantly smaller volumes than the current standard; limited initial issuance, through a small number of investors, with the objective of a subsequent larger issuance; and company listings (without an initial public offering) that would help a company increase its exposure to investors and improve its prospects for future offerings.

The exchange is also in the process of developing a Business Sustainability Index (BSI). The BSI will evaluate 40 companies that have shown a commitment to social-environmental policies and financial sustainability. A nine-member deliberation group, including the **International Finance Corporation**, the **Brazilian Institute for Corporate Governance** and the **Environmental Ministry**, is working on the index.

There were two noticeable trends in the Brazilian proxy season. The first was proposals for reverse stock splits. The second was proposals to make their supervisory board a permanent body with many features of U.S. audit committees. Following Bovespa recommendations aimed at increasing trading and liquidity, 14 companies have included reverse stock split proposals on their agendas this proxy season alone. The other noticeable corporate governance trend long sought by investors was to make company supervisory boards, which in Brazil have an auditing function, permanent, or to create an audit committee outright.

New Independence Requirements in Colombia
The Senate approved a new Capital Markets Law in June that includes a 25 percent independence requirement for public company boards. The law originally proposed a 40 percent standard, but lawmakers agreed to a lower minimum after a strong outcry and lobbying by companies and the **National Association of Industries**. An estimated 68 percent of companies in Colombia are family-owned, which explains their strong reluctance to share control with outsiders.

The board independence provision will be implemented gradually to allow companies a smooth transition. During the first year in which the law becomes effective, at least one board member must be an outsider; companies must reach the 25 percent requirement within three years. Other provisions of the law will require that an individual agent may not hold more than 10 percent in a stock exchange, and will promote transparency in the disclosure of shareholder agreements.

The government also announced in June that it plans to merge the bank regulatory agency and the securities and exchange commission. Other government plans include the introduction of a three-tier listing system--similar to the one used by Bovepsa, the Sao Paolo exchange in Brazil--in which companies would be classified according to financial and corporate governance standards set for each segment. Meanwhile, the country's stock exchange, ***Bolsa de Valores Colombiana*** is seeking more far-reaching changes in listing requirements, including a minimum required equity of the equivalent of $3 million and a record of positive operating income in the preceding three years, according to Elizabeth Prada, the bourse's legal counsel.

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Capital Market Reform in Chile Nears Passage
After languishing for almost two years, Chile's capital market reform proposal appears set to move ahead to passage before President Ricardo Lagos' term expires next year. Lagos has voiced a commitment to approve this legislation before the end of the year. Recently, Guillermo Table, director of **Santander Investments**, urged legislators to expand the scope of the proposed reform, calling for a more flexible approach to encourage foreign venture capital and direct investment.

In addition to promoting venture and seed capital funds, the legislation seeks to provide regulators with more effective oversight tools, revise tax and bank regulations and introduce new norms of corporate governance. The bill would require at least two independent directors on the board of any public listed company with high equity; it defines procedures and disclosure requirements in related party transactions; and it mandates the rotation of independent auditor firms at least every five years, unless the minority shareholders agree otherwise.

New IPO and Securities Disclosure Rules Sought in Peru
Conasev, Peru's securities regulator, is modifying the country's IPO and securities regulations to reduce the time span in which information has to be provided and expand the scope of information required. The amendments seek to provide greater transparency for all participants involved in public offerings and reduce the risk of fraud by brokers or agents, the agency said. The measure requires approval by the Ministry of Finance and passage by the legislature.

The proposed modification would require all brokers and/or agents to submit all documentation regarding the results of the IPO process by the next business day, in accordance with the format approved by Conasev. This information should indicate the type of securities, the amount offered, the total amount acquired, and the interest rate or implied yield. The current regulation only requires the issuer to submit information with respect to the final outcome of an IPO.

Mexico Considers Securities Law Reform
In March, Mexican lawmakers introduced market reform legislation. The bill, subject to congressional approval, would more clearly define accountability, improve disclosure and transparency and increase minority shareholders' rights. The reforms also would target market practice violations and establish a new listing class for medium-sized companies that are not ready to face the rigorous requirement of a regular listing on the stock exchange.

Known as SAPI, the acronym of *Sociedades Anonimas Promotoras de Inversion* ("Investment Promotion Group"), these companies would not be obliged to comply with the reporting regulations imposed on public companies. Should these SAPI companies decide to become fully listed, they would be given a three-year grace period before having to make full accounting disclosures. Alternatively, a SAPI could choose to keep that status throughout its existence.

At the same time, investors in SAPIs would benefit from a number of expanded shareholder rights. Shareholders with 5 percent voting rights can take actions against the board of directors. Shareholders with 10 percent of the voting rights can designate a director or call a shareholder meeting. Finally, shareholders with 20 percent voting rights can take legal actions against a resolution passed at a shareholder meeting.

Governance at a Crossroads:

2006 Proxy Season Preview/2005 Review

Carol Bowie, VP, ISS Governance Research Service
Patrick McGurn, EVP & Special Counsel, ISS

October 2005

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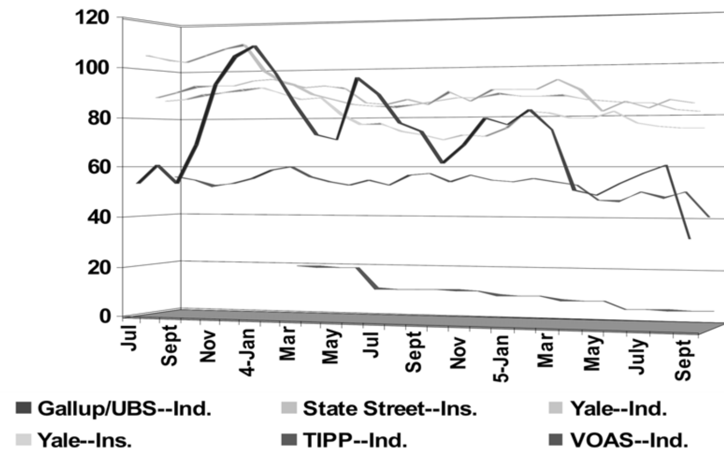
Shareholder optimism/confidence plummets

Investor Optimism in Post-Katrina Freefall



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The *T-Word*
Governance & accounting impact trust level

- 42% of individual investors say "*questionable" accounting* continues to hurt investment climate "a lot"
  - Gallup/UBS Index of Investor Optimism (*Conducted July 1-17*)
- Only 8% of Americans have a "great deal" of confidence in Big Business
  - Nearly one-third (29%) have "very little" confidence
  - Beats only HMOs at 7% "great deal" vs. 35% "very little"
    - Gallup Poll (*Conducted May 23-26*)
- Nearly 40% of retail investors are "not very confident or not confident at all" that CEOs engage in ethical business practices
  - Opinion Research Corp. (*March 2005 cited in Chief Executive, May 2005*)
- 24% of Americans have "hardly any" confidence in the people running major corporations; only 17% have a "great deal" of confidence
  - Harris Interactive (*Conducted February 8-13*)

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Proxy seasons by the numbers

2003	2004	2005 (Partial/Estimate)
▪ Directors/Boards – W/H @ 38% ('02: 52%) – 25% of nominees – Proxy fights: 30 ⇓ ▪ Shareholder props – First 1K season (693) – Withdrawals: 10% – ISS supports: 50% – Majority votes: 172 (24.8%) ▪ Auditors: No @ 7% ▪ Compensation – All plans: Against 29% – Option plans: 32% – P-F-P: NA	▪ Directors/Boards – W/H @ 32% ⇓ – 20% of nominees ⇓ – Proxy fights: 19 ⇓ ▪ Shareholder props – Second 1K Season (703) – Withdrawals: 20% ⇑ – ISS supports: 44% ⇓ – Majority: 138 ⇓ (19.6%) ▪ Auditors: No @ 3% ⇓ ▪ Compensation – All plans: Against 25% ⇓ – Option plans: 28% ⇓ – P-F-P W/H @ 25 firms	▪ Directors/Boards – W/H @ 29% ⇓ – 17% of nominees ⇓ – Proxy fights: 13 ⇓ ▪ Shareholder props ⇓ – Third 1K Season? (576) – Withdrawals: ⇑ – ISS supports: 54% ⇑ – Majority: 105 ⇓ (18.2%) ▪ Auditors: No @ 3% ▪ Compensation – All plans: Against 30% ⇑ – Option plans: 34% ⇑ – P-F-P W/H @ >60 firms

Less confrontation. more engagement were hallmarks of 2005 Season except on executive pay where conflict continues to spread.

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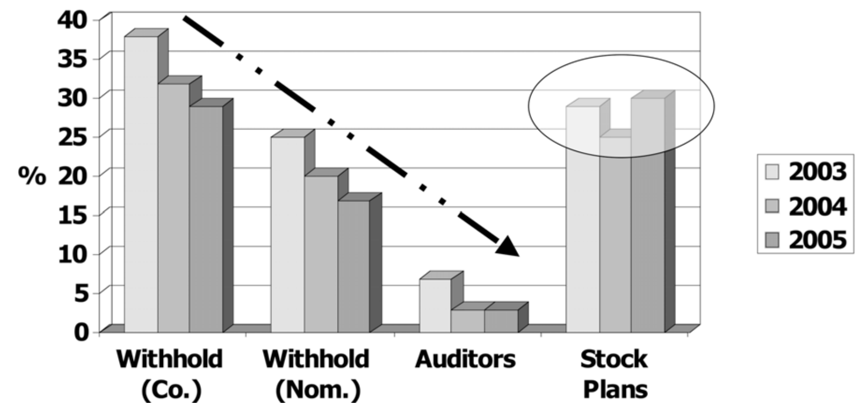
Reforms lead to fewer negative recommendations



Less confrontation. more engagement were hallmarks of 2005 Season except on executive pay where conflict continues to spread.

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2006 & beyond: The forks in the road

Will Corporate Governance Reform Move in New Directions?

- End of Market Reform Era?
  - Donaldson left unfinished agenda; Cox arrives with deregulatory urge
- Eve of Majority Rule Era?
  - The election of directors: Majority-lite or plurality plus?
- Independent Board Leadership?
  - Pick one: independent chairs or lead/presiding directors?
- Accountability: Who Decides? Directors or Shareholders?
  - Classified board or annual elections?; Unilateral boards action or shareholder votes on pills?
- Pay-for-Performance or Pay-for-Failure?
  - Stock options/restricted stock or performance awards?
- Have Hedge Funds Claimed Leadership of Shareholder Activism Movement?
  - "Passive" public/labor funds or "active" investors; Two key numbers: $1 Trillion and $1 Billion
- Will Corporate Social Responsibility Go Mainstream?
  - Market risk or social engineering?

Now that Sarbanes-Oxley rules and the Stock Exchanges' Listing Changes are in place at most companies, activists seek to identify the agenda for the Post-Enron Era.

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The end of the reform era?

Ex-Chairman William Donaldson

- Unfinished agenda (3-2)
  - Delay on Section 404
  - Mutual fund governance
    - Fait accompli
    - Legal challenge
    - Re-vote challenge?
  - Hedge fund regulation
    - Legal challenge
  - Delay of FASB's Expensing Rule
    - My biggest mistake…Part II…
  - Compensation disclosure revamp
    - Too little, too late
- Momentum had been lost
  - Board access proposal already dead

Chairman Chris Cox

- Shift in balance of power (2-3)
- Cox on Sox Section 404
  - Balance interests of business and accounting profession
- Mutual fund governance
  - Legal challenges are key
- Hedge fund regulation ⇑
  - Again, legal challenges are key
  - The Pitt-falls of the job
- Option expensing ⇑
  - Pick your fights: "go forward"
- Executive compensation ⇑
  - Disclosure over substantive regulation: supports "clearly understandable" disclosure; one number

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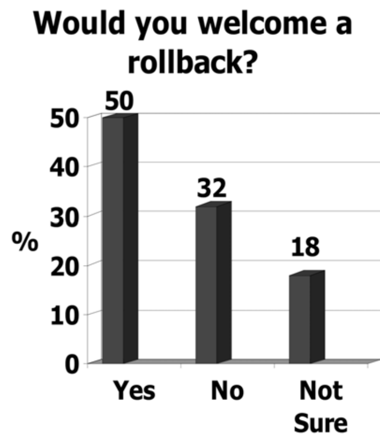
Investors want to balance SOX's costs and benefits

- Half of investors would "welcome" a rollback of SOX regulations
  - 78% favor selective rollback over broad-based
- 63% of investors said costs of compliance are not commensurate with benefits
  - Only 16% say costs/benefits are in balance
- 60% said regulatory environment is likely to moderate over next five years from where it is now to balance costs and benefits
- 59% say regulations have made companies "more guarded" and "less communicative"
- Investors split on whether Cox will benefit markets and investors
  - 39% said "yes"/17% said "no"/44% "not sure"
- 76% say major stock exchanges could do a better job of policing their members
  - **Survey of 91 portfolio managers and buy side research professionals, July 2005, Broadgate Consultants**



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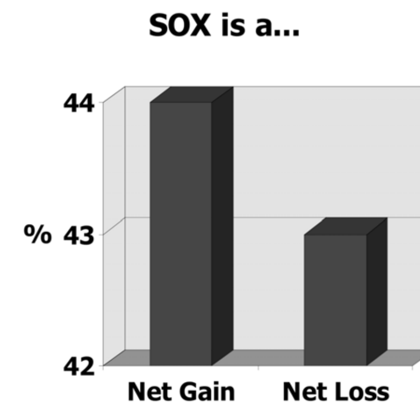
Executives want to lower SOX costs, but cite benefits…



- **66%** of CEOs said SOX has made directors **"more informed"**
- **72%** said SOX made directors **"better engaged"**
- 37% of CEOs said it is easier to attract investors than it was five years ago
  - Survey of 103 CEOs (April-June 2005) by Schulman, Ronca & Bucuvalas for the NYSE CEO Agenda 2006
- **74%** of Nasdaq issuers believe SOX is **necessary**
- **66%** of Nasdaq issuers have **identified real benefits** associated with Section 404 including better control and investor confidence
  - Survey of Nasdaq issuers, September 2005
- Financial executives view SOX as a "net gain" overall for investors and market
- **87%** of senior financial executives cite SOX as a **"top priority" for boards**
- **42%** called SOX **"a way to improve our business controls and processes"**
  - 28% called it a "*corporate tax*"
    - Survey of 200 financial officers (July 20-25) by Lake Snell Perry Mermin and Associates/Decision Research for Approva Corp.

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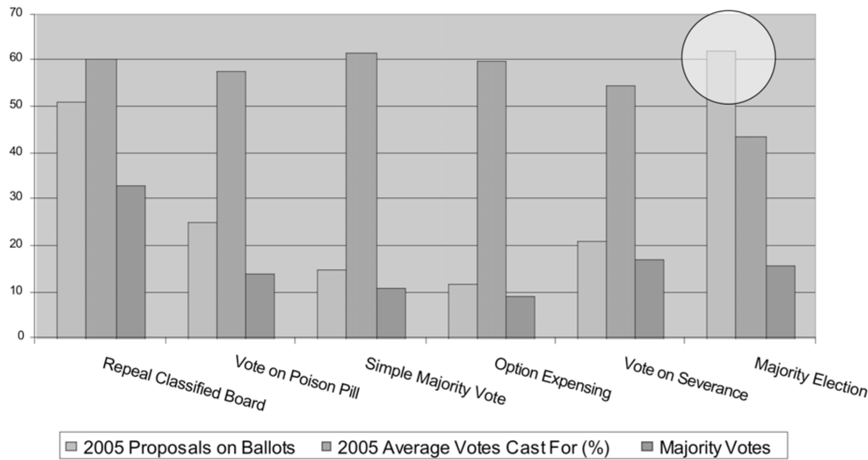
Big 6 proxy season issues



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Crossroads: What's next for boards: plurality or majority?

- Change from plurality
  - >80 props from Building Trades
    - New Policy: ISS "For" '05 Model
  - **44% average on 57 proposals**
    - 2004—tepid support (<12%)
    - **16 majority votes** @ Advanced Micro Devices, Altera, BEA Systems, Federal Realty Investment Trust, Freeport-McMoRan Copper & Gold, Host Marriott, Liberty Property Trust, Mack-Cali Realty*, Marathon Oil, Marsh & McLennan Cos., NiSource, Office Depot*, Raytheon, SuperValu, UnumProvident & Xilinx
    - 2005-2006—Binding bylaw proposals (Paychex in 2005 – only garnered 20%; Morgan Stanley & others in 2006)
  - State law/listing standard change?
    - ICGN, CII (letters), ABA Task Force (**BRT-No**)
      - Comment period closed at ABA
    - Working Group of 13 includes
      - Baxter, ChevronTexaco, Cinergy, Constellation Energy, Gap, Intel, JPMorgan Chase, Merrill Lynch, Time Warner & Wyeth
    - Majority Vote Trailblazers: ADP, Lowe's & Dillard's
    - Nearly 20 Plurality-Plus Trailblazers: Resignation Offered Following Majority Withhold
      - Cast (15): Aetna, Altria, Avnet, Colgate-Palmolive, Fastenal, Gap, Health Mgmt. Assoc., John Wiley and Sons, Lucent Technologies, **Mack-Cali Realty***, Microsoft, Pitney Bowes, Pfizer, Prudential Financial, & Walt Disney
      - Outstanding (4): Circuit City, Office Depot,* United Technologies and Wells Fargo
    - 25+ Companies already have ME standards; N-Viro (class action settlement)

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Majority-lite vs. Plurality-plus

- Majority-lite
  - Alters front-end (vote requirement)
  - Limited change to back-end (consequences of vote results)
    - Possible defeat of new nominees
    - Incumbent nominees will keep seats under state law "holdover" rules
  - Issues
    - Shares outstanding vs. votes cast
    - Ballot issues
      - Against vs. "withhold"
    - Carve-out for contested elections
      - Possible anti-takeover defense
      - Issue at Paychex
        - ISS recommends "no"
- Plurality-plus
  - No change to front-end (vote requirement)
  - Majority withhold vote triggers "voluntary" process on back-end
    - All unopposed nominees (new or incumbent) are elected
    - Large withhold vote triggers offer(s) of resignation by impacted nominee(s)
  - Issues
    - Shares outstanding vs. votes cast
    - How does the process work?
    - Enforceability of policies
      - Director removal process

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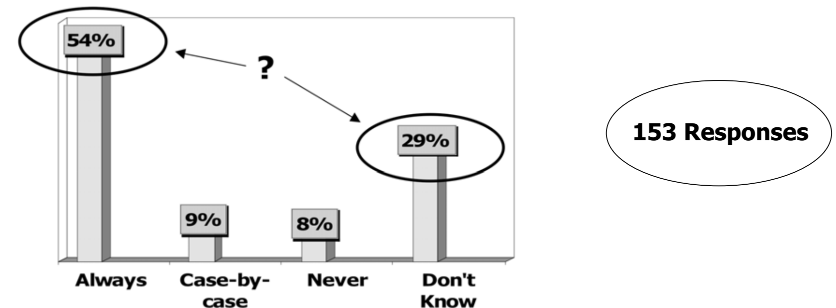
Support for binding proposals

ISS Policy Jam Question on Majority Voting Binding Proposal

– ***Should shareholders should support a binding proposal to adopt a majority vote standard for director elections?***



Among many institutions, the MV standard receives very strong support; for others it poses a level of uncertainty and raises several questions.

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Rise of the mega-no vote campaign

Withholding Votes is The Focus of Activism.

- Huge withhold votes
  - A new form of proxy challenge ("none of the above")
  - '05: To date, almost 40 30 percent-plus "W/H's"
    - '04: >40 S&P 500 board nominees drew 30 percent-plus W/H's
      - A handful of withhold votes above 50%, including small- and mid-caps!
  - '05: To date, few large, organized "no" vote campaigns
    - **Pseudo-proxy fight at Career Education**
      - **60%+ withheld (80% w/o broker votes)**
    - '04: Handful of organized campaign/active solicitation
      - Disney (Shamrock), MBNA (TIAA-CREF), Safeway (State Funds/Unions)
  - '05: Fewer policy-driven "no" votes, but it's still early
    - '04: Hundreds of policy-driven "no" votes

In 2004, withhold votes supplanted shareholder proposals as the major form of activism at annual meetings. So far in 2005, vote "no" campaigns have been muted.

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What factors drive large (30%-plus) "no" votes?

Company/Board Specific

- Ignore majority votes on shareholder proposals
  - 38% @ McGraw Hill
    - Pill gone
  - Ignore Majority "Withhold" Vote
- Excessive non-audit fee payments
- Overlook obvious board conflicts
- Pill popping without votes
  - Adopt "dead hand" poison pill
- Will "restatements" or "internal control" problems make the list?

Director Specific

- Affiliated outsiders on key boardroom committees
  - Audit, compensation, nominating/governance
    - 44% at Sanmina-SCI (Rosati)
- Poor attendance
- Over boarding
  - Too many boards!
  - New Policy!
    - Sitting CEOs
      - 3-public co board limit

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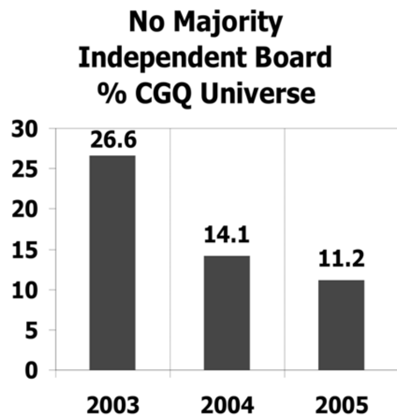
Board independence still attracts attention



- Investors raise ceiling
  - Simple majority isn't enough
    - 75% of S&P 500 already exceed two-thirds
    - **NEW!** Q3 '05 CGQ upgrade
- Expect more clashes over director designations
  - 2004: A "dry run" at the NYSE; define and describe; somewhat better in '05
  - 2005: ISS Changes
    - 5-Yr. cool off for former execs, except CEOs
    - Conflicts for "immediate family members"
- Related party transactions (7K)
  - **New!** Q3 '05 CGQ upgrade
  - Fortune 100 get letters from CalPERS

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Crossroads: Who leads the board?

Activists Push for Independent Chairs as Default

Independent Chair vs Lead Director

- CII prefers IC
  - LD as limited exception
- ISS backs choice: IC or LD
  - Meaningful "lead" vs. "presiding"
- ISS's formal LD duties
  - Preside at executive sessions
  - Call board meetings
  - Liaison between chair/investors
  - Approve information, agendas and schedules
    - Performance is a factor

2005 Proxy Season Results

- 29% average on 28 proposals, so far
  - Majority vote: Textron (50.4%)
  - Merck (47%--CEO goes, no new chair)
- <10 percent of S&P 500 boards have truly independent chairs (Walt Disney)
  - CEO is chair at 70%
  - On 130 boards where the CEO is not chair, 75 percent are **not** independent
  - 62% have non-rotating lead or presiding (52% in '04)
    - *2006 Board Practices/Board Pay*

From the perspective of good governance, how do you view the importance of... separating the chairman and CEO roles? Important: 46%; Very Important 27%
•Survey of 100 pension funds, money managers and hedge funds by Pensions&Investments/Vivient Consulting (March 2005)

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Other boardroom reforms/ratings

Emerging Boardroom Issues

- Over boarded directors
  - Six or fewer seats; W/H recommendations few and far between
  - 3-public company board limit for sitting CEOs
- **New!** Q3 '05 CGQ upgrade: director evaluations
- FTSE ISS Corporate Governance Index Series went live in April 2005
  - Screened for governance
- What's next? Personal contributions to settlements
  - WorldCom directors agreed to pay $18 Million; Enron's, $13M
  - Gross negligence proposals at Time Warner, Verizon…
- What's next?: Ratings of individual directors
- What's next?: Certification
  - NACD's Corporate Directors Institute
    - Director Education Certificate Program

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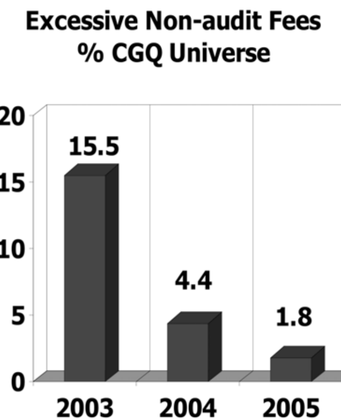
Audit focus shifts from non-audit fees to SOX Section 404

- Audit fees up; non-audit fees down
  - CalPERS rethinks zero tolerance policy ('04: W/H @ 90% Firms)
    - '05: Votes against auditors for conflicts
  - '05: >10 zero tolerance proposals
    - Limited support
  - ISS retains 50/50 Policy ('04: recommended against <120 firms)
    - Audit+Audit Related+Tax Filing/Compliance>All Other Fees
- Ratification proposals draw settlements
  - S&P 500 goes from 67% to 85%
- Rotation (audit firm, not partner)
  - Proposals a "no show"
  - How long is too long? 10 years? 20 years?
- **New!** Q3 '05 CGQ add: financial experts
- Response to SOX Section 404 disclosures
  - Withhold votes? Candor and cure are key



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Accountability: Annual boardroom elections

Momentum to Destagger Director Terms

- New evidence drives support for shareholder proposals
  - **2005: 61 percent average support on 43 proposals**
  - **Majority votes at 33 companies so far including** ABX Air, Alaska Air Group, Associated Banc-Corp, Aztar, Ball, Baxter International, Bed Bath & Beyond, Boeing, Boston Properties, Career Education, Centerpoint Energy, Charles Schwab, Genzyme, Icos, Interdigital Communications, J.C. Penney, Kohl's, Layne Christensen, Longs Drug Stores, Luby's, Marathon Oil, Marriott International, Newell Rubbermaid, NiSource, Officemax, Peabody Energy, Reliant Energy, Schering-Plough, Sempra Energy, Stanley Works, Tidewater, UNOVA, Visteon, Weyerhaeuser & Wintrust Financial

From the perspective of good governance, how do you view the importance of... Re-electing directors annually? Important: 37%; Very Important 23%

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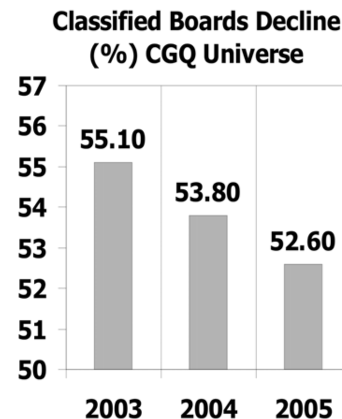
The return of annual elections



- Repeal proposed at >65 firms
  - American Income Fund, Inc., AMLI Residential Properties Trust, Archstone Smith Trust, Avon, Baker Hughes, Banknorth Group, Bausch & Lomb, BioSyntech, BKF Capital Group, Borland Software, Calpine, Canyon Resources, Conagra Foods, Cutter & Buck, Digital Recorders, Duke Energy, Eastman Kodak, EDS, Exide Technologies, Federated Department Stores, Gartner, Gemstar-TV Guide Int'l., Goldman Sachs Group, Harsco, Heritage Commerce, Homestore, Honeywell Int'l., Horizon Offshore, Jones Lang LaSalle, May Department Stores, Maytag, Microtune, Morgan Stanley, **Nasdaq Stock Market**, North Valley Bancorp, Northrop Grumman, NTN Communications, P-Com, Pegasystems, Pepco Holdings, Photoworks, Pizza Inn, Power-One, ProLogis, Prudential Financial, QAD, Raytheon, Realty Income, Sabre Holdings, Sensient Technologies, Shurgard Storage Centers, Southern Union, Stratos International, Syntel, The Banc Corporation, Timco Aviation Sevices, TJX, Tractor Supply, Trimeris, W.P. Carey, Water Pik Technologies, Wave Wireless, WCI Communities & Yum Brands
- But see Georgia-Pacific (FAILED/Recs **No**), Goodyear Tire & Rubber (FAILED/**No Bd. Rec**); Qualcomm (FAILED/Bundled); Back at Proctor & Gamble for 2006

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Accountability: Shareholder votes on rights plans

Simple Majority Vote Also Attracts Strong Support

- Proposals continue to receive strong support
  - **58 percent on 22 resolutions, so far**
  - **14 majority votes** (41 majority votes in 2004*)
    - ADC Telecommunications, Alaska Air Group, AT&T, Career Education, Caterpillar, Imperial Sugar, IMS Health, Liberty Corp., McGraw Hill Cos., Peoples Energy, R.H. Donnelly, Sempra Energy, Sierra Pacific Resources, The Pep Boys - Manny, Moe & Jack
- W/H on directors unless vote promised (WatchGuard Technologies—12 months)
  - Advanced Marketing Services, Alliant Techsystems, Alnylam Pharmaceuticals, Alteon, ATP Oil and Gas, August Technology, Axonyx, Bentley Pharmaceuticals, Beverly Enterprises, Calgon Carbon, Capstone Turbine, Cenveo, CoSine Communications, Depomed, Digitas, Digital Impact, Eagle DE , EDGAR Online, Eyetech Pharmaceuticals, Farmer Bros., FEI, Firstmark, Genta, Indus Int'l., Intrawear, JPS Industries, Knology, Main Street Restaurant Group, Mattson Technology, Medicis, Navigant Int'l., Neurobiological Technologies, **News Corp. (2 more years),** Noble, Overland Storage, OXiGENE, Pac-West Telecom, Pain Therapeutics, Park Electrochemical, Pentair, Pozen, Qualcomm, Renovis, Rudolph Technologies, Senomyx, Smith & Wesson, SOURCECORP, Tsakos Energy Navigation Limited, Teton Petroleum, Tikcro Technologies, Waters Instruments & Wheeling-Pittsburgh
  - See 62% support for board's rights plan adoption at Ryan Restaurants
- Simple majority vote draws 62 percent average support so far
  - Majority votes at 12 firms
    - Alaska Air, Albertson's, Boeing, Citigroup, CSX., Federal Express, FirstEnergy, H.J. Heinz, Kroger, Lockheed Martin, Northrop Grumman & SBC Communications

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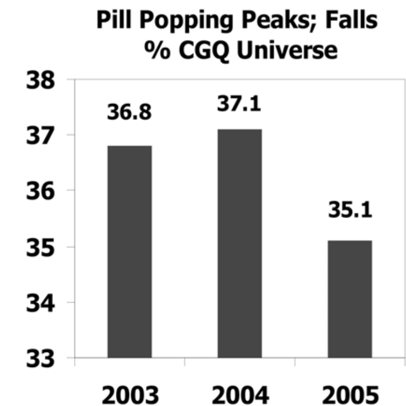
Shareholder approval with sunset fiduciary outs

- 20 pills going or gone in '05
  - A.G Edwards, Bank of New York, BKF Capital Group, Calpine, Career Education, Caterpillar, Choice Hotels, Cisco Systems, Colgate-Palmolive, Cornell Cos., Cutter & Buck, eGames, Exar, Heritage Commerce, Lam Research, Level 3, McGraw-Hill, Morgan Stanley, PhotoWorks, ServiceMaster, SpaceHab & Wintrust Financial
    - >25 firms redeemed pills in 2004
- Fiduciary outs with 12-month sunsets
  - More than 30 firms, so far, including A.G. Edwards, CSX, El Paso, First Energy, Fortune Brands, Home Depot, Kimberly-Clark, McGraw-Hill, Morgan Stanley, Raytheon & ServiceMaster
  - Chevedden pushes for four months (28% for 12-to-4 proposal at PG&E)



Please rate your attitude toward shareholders having the right to vote on…Adoption of poison pill? Agree: 29%; Strongly agree: 49%

•Survey of 100 pension funds, money managers and hedge funds by Pensions & Investments/Vivient Consulting (March 2005)

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Excessive executive pay: Not a victimless crime

Incentives Work: Be Careful What You Ask For…

- Poor Pay Practices Promote…
  - Fraud
  - Restatements
  - Shareholder Litigation
  - Higher Risk Strategies
  - Poor Returns
    - The Plane, The Plane

What do you think will be the single most important governance issue in the future? Executive compensation: 34%…Shareholder access: 6%

•Survey of 100 pension funds, money managers and hedge funds by Pensions & Investments/Vivient Consulting (March 2005)

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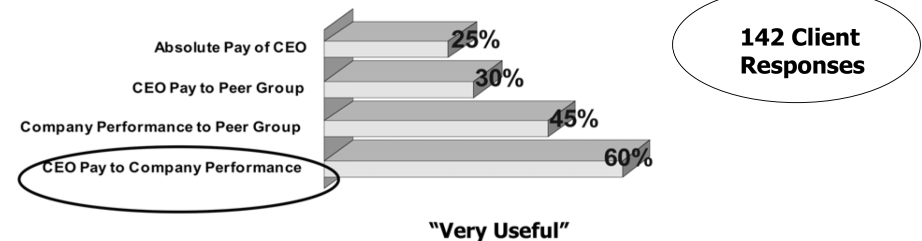
Shareholders: link pay to performance

Policy Jam Question on CEO Pay

- How useful are the following factors in measuring the appropriateness of a CEO's pay package as it relates to job performance?



When you are evaluating a company, how important is the level of executive compensation? Very Important 12%

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Executive pay: Shareholder proposals

P-F-P was Pig in '05 Season Python

- Use more P-F-P awards
  - >30 percent average support on 38 proposals, so far
    - Majority vote at Lucent Technologies (50.2%)
      - High votes at Textron (48.6%), Gannett (45.8%), EMC (43.4%), Albertson's (43.3%), US Bancorp (42.7%), UnitedHealth Group (42.6%), PG&E (39.1%), Novell, (ISS Against: 34%)
- Excessive severance
  - 59% of investors are opposed to golden parachute arrangements
    - Survey by P&I/Vivient Consulting (March 2005)
  - '05: 55 percent average support at 21 firms, so far
  - Majority votes at 17 firms ('04: Majority votes at 15 Firms)
    - Albertson's, AT&T, Arden Realty, Cendant, ChevronTexaco, Edison International, Halliburton, Hilton Hotels, Home Depot, Kohl's, Kroeger, Lucent Technologies, Mattel, Occidental Petroleum, PG&E, Republic Services, & Waste Management

When voting the proxy, how important is the company's performance in the following areas: Executive compensation policies?

Important: 43%; Very Important 46%

•Survey of 100 pension funds, money managers and hedge funds by Pensions & Investments/Vivient Consulting (March 2005)

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Executive pay: Shareholder proposals

P-F-P is Pig in '05 Season Pay Proposal Python

- Option Expensing, back due to six-month delay
  - '05: 60 percent average support on 11 proposals, so far
  - Majority votes at nine firms
    - Adobe Systems, Aetna, Altera, Analog Devices, ChevronTexaco, Dell, MBNA, Sempra Energy, Starwood Hotels and Resorts & Weyerhaeuser
      - '04: 22 majority votes (33 on Ballot), including H-P, IBM (adopted) & Intel
  - Will Congress intervene, again?
    - Cisco's valuation alternative fails to pass muster at SEC
- Claw back gains following earnings restatements
  - Most proposals still don't require fraud
  - 29 percent average support so far
    - Bristol-Myers Squibb (ISS Against: 22%), JP Morgan Chase (ISS For: 38%), Dynegy & Qwest (32%)

75% of investors said average CEO pay ($10.5 m) at major companies is too high.

• Survey of 88 major institutional investors by Pearl Meyer & Partners (April 2005)

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Votes on compensation committee members

Aligning Pay and Performance

- ISS places focus on members of compensation committee
  - –ISS's P-F-P disconnect test
    - Negative 1- & 3-year total shareholder returns and increase in CEO pay
  - –'04: Only two dozen firms triggered ISS's P-F-P policy
    - 230 other drew "cautionary notes"
  - –'05: *Withhold recommendations at more than 55 firms*, so far
    - **Nearly 10 S&P 500 firms**
      - –Including Dow Jones, Novellus Systems, Sanmina-SCI & Visteon
      - –Early results are mixed; withholds generally at 20 percent level
    - Also see withholds at Cendant (excessive salary/bonus), Gillette (excessive option grants/severance) & Yahoo! (excessive options grants)
  - –Cure—Pay panel at Morgan Stanley met the test, but…

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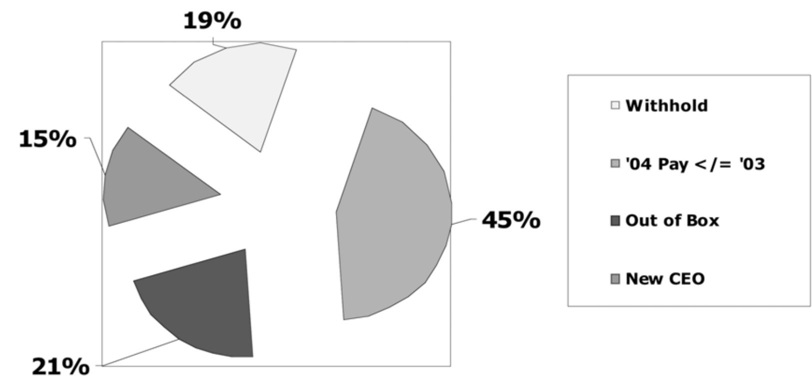
Potential pay/performance disconnects: What's the story?



From the perspective of good governance, how do you view the importance of…using a pay for performance system to compensate top executives? Important: 40%; Very Important 42%

- *Survey of 100 pension funds, money managers and hedge funds by Pensions&Investments/Vivient Consulting (March 2005)*

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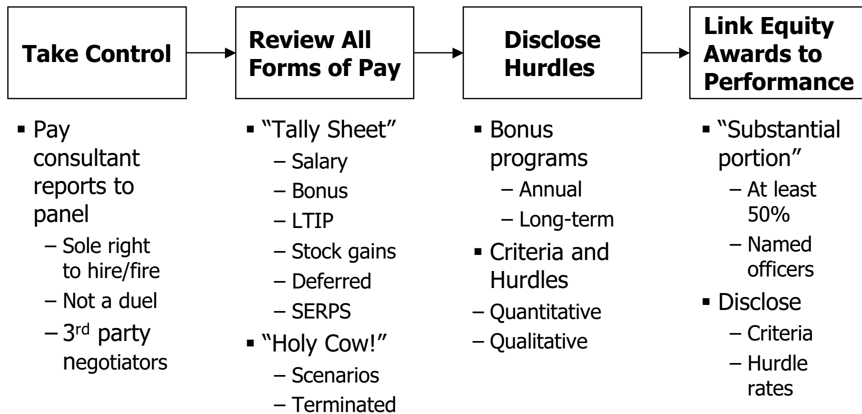
VALUE AND ACTIVITY CHAINS

How do pay panels exit the penalty box?

Directors Must Show Signs of Reform



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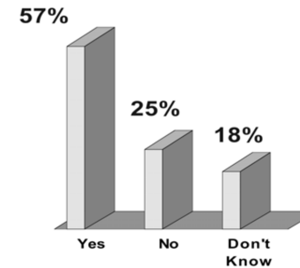
2006: Going after the 4-letter words—Perk, SERP, CINC…

Policy Jam Survey Question on Perquisites

- *In general, are you in favor of withholding from the compensation committee for questionable or egregious practices that may not involve significant tangible compensation, but rather more perquisites such as (but not limited to) personal use of company aircraft, country-club memberships or tax gross-ups?*



138 Client Responses

Majority of respondents favor action against compensation committee for questionable practices.

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The perk parade…Footnoted.org's greatest hits

Personal use of corporate aircraft: Apparently, Leucadia National Corp. President Joseph Steinberg has lots of free time on his hands — enough to burn through **$743,556** in personal use of the Gulfstream last year. Not only is that 20% more than Steinberg spent in 2003 on personal air travel and more than his salary of $630K…Adding Steinberg's spending to that of Leucadia Chairman Ian Cumming and you realize that investors spent nearly $1 million on personal air travel for the two top executives. Source: Footnoted.org	**Club dues:** Lots of deals have taken place…on the golf course. It's one of the reasons many companies…(use)…to justify paying for golf club memberships…But how much is too much to spend on the perk?…USI Holdings has decided to spend … **$600K** to purchase a membership at a golf club…for three of its top executives…. Source: Footnoted.org
Financial advice: It must be awfully difficult to afford the necessities in life like tax planning when you're only making around $4 million a year, as ChoicePoint CEO Derek Smith did last year. Though Smith's bonus, disclosed in the recent proxy, has been widely reported, the fact that ChoicePoint spent nearly **$100,000** on Smith's financial planning and tax fees, hasn't received much attention." Source: Footnoted.org	**Car and Driver**: When it takes two pages of footnotes to explain a summary compensation table, you know there's got to be something interesting… And so it is with American Express' recent proxy. Beyond the compensation, which has already been widely reported, the footnotes show that Amex spent **$118,582** to provide Chairman and CEO Ken Chenault with "local transportation" which in proxy-speak means a car and driver. Source: Footnoted.org

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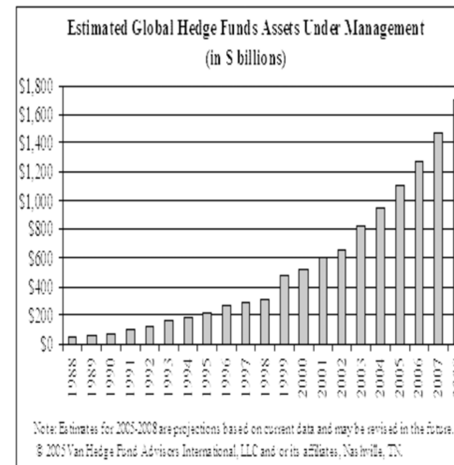
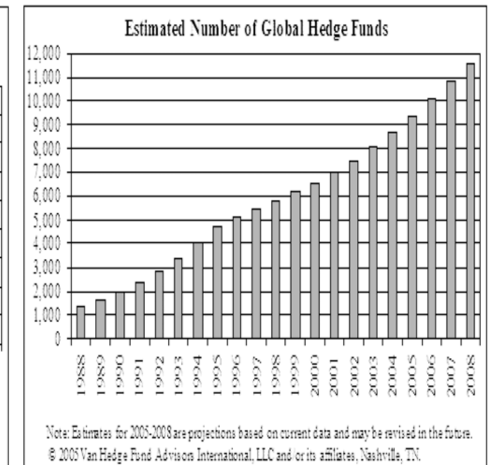
Growth of hedge funds





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The M&A scene: No more "friendly" deals

Friendly or Hostile

- Gillette-P&G
  - Contested by pols
- MCI-Verizon
  - Deal-jumper: Qwest
  - No: *Deephaven Capital*
- Shurgard-Public Storage
  - Hostile bidder
- Unocal-Chevron
  - Deal-jumper: CNOOC
  - National security

Contested

- Computer Horizons
  - *Crescendo Parters/Eric Rosenfeld* killed deal with Analysts Int'l.
- Johnson Outdoors
  - *Dolphin Ltd.* Killed LBO
- Mylan Labs
  - *Icahn* blocked King Pharma deal
- Providian-WaMu
  - Putnam Funds opposed; Approved
- Shopko Stores
  - *BKF Capital/ Elliott Assoc.* opposed LBO; Sweetened

Hedge Funds

- Beverly Enterprises
  - Appaloosa, *Formation Capital*, (Hostile bid/PF); Settled; "Auction" called
- BKF Capital Group
  - *Steel Partners II* (PF-won 3 seats); Co-opt: extreme MO
- Circuit City
  - *Highfields Capital Mgmt LP* (Hostile bid)
- Cornell Cos.
  - *Pirate Capital LP* (PF); settled for control

Hostile offers…3rd-party bidders…deal-jumpers…bear hugs…contested solicitations Hedge funds, public pension funds, mutual funds, politicians, media and others challenge "friendly" deals. Boards settle proxy battles.

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Hedge Funds Lead Push for Immediate Value

Company	Dissident	Outcome
Acxiom	ValueAct Capital Partners/Jeffrey Ubben	Hostile offer
Beverly Enterprises	Appaloosa, Formation Capital	Hostile offer, proxy fight, **SETTLED**, auction
BioMarin Pharmaceuticals	OrbiMed Advisors/Samuel Isaly	Proxy fight, **SETTLED** (2+1)
BKF Capital Group	Steel Partners II/Warren Lichtenstein	Proxy fight, **DISSIDENT (3)**
Blockbuster	Carl Icahn	Proxy fight, **DISSIDENT (3)**
Cenveo	Burton Capital Mgmt./Robert Burton	Proxy fight, **SETTLED For Control**
Circuit City Stores	Highfields Capital Mgmt./Richard Grubman	Hostile offer
Cornell Companies	Pirate Capital/Thomas Hudson	Proxy fight, **SETTLED For Control** (7 of 9 seats)
Cutter & Buck	Pirate Capital	Threatened proxy fight, **SETTLED,** pill classified board going
Johnson Outdoors (Going Private)	Dolphin Limited Partnership I LP/Donald Netter	**MBO dropped**
Kerr-McGee	Carl Icahn	Threatened proxy fight, **SETTLED (Buybacks, asset sales)**

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Hedge Funds Lead Push for Immediate Value

Company	Dissident	Outcome
Mylan Labs	Carl Icahn	Hostile offer, threatened proxy fight, **DROPPED** (buyback)
OfficeMax	K Capital Partners/Brian Steck	Threatened proxy fight, **SETTLED**
Register.com	Barrington Capital/Mark Cuban	Barrignton **SETTLED**; Cuban plans to vote against merger with Vector Capital
Sears Roebuck	ESL/Eddie Lampert	**Merge with Kmart/DONE DEAL**
Six Flags	Red Zone LLC (Daniel Snyder)	Threatened proxy fight; auction offered by board
Sovereign Bancorp	Relational Investors LLC/Ralph Whitworth	**DROPPED** Board changed compensation practices
Time Warner	Carl Icahn	Threatened proxy fight (Buyback/spin-off)
Topps	Pembridge Value Opportunity Fund LP	Threatened proxy fight, **SETTLED** (Strategic Alternatives, Drop Pill), May Return
Wendy's	Pershing Square Capital (17%) & Highfields Capita/Richard Grubman	Threatened proxy fight, **DROPPED** (Buyback, Dividend Boost, Asset Sale, Spin-off)

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Carl Icahn
Raider Reincarnated at Activist Hedge Fund Manager

- Blockbuster
  - Won three board seats
- Kerr-McGee
  - Big buyback, asset sales
- Mylan Pharmaceuticals
  - Killed deal with King Pharma
  - Big buyback
- Siebel Systems
  - Selling to Oracle
- Time Warner
  - Possible proxy fight

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Social issues continue to draw support and settlements

Market Risk is Key

- 2005: Settlement fever spreads
  - Fewer high votes on social concerns; sponsor more governance props
  - Global warming/environmental risk
    - 30 proposals on greenhouse gas reports; only 11 made it to ballots
      - Nine at oil and gas (nearly all settled), six manufacturers, three electric utilities and two automakers
  - Employment discrimination
  - Human Rights/ILO standards
- Hot in '05-'06: Sudan (divestment), terrorism, soft $

85% of executives and investors rank "corporate responsibility" as a "central" or "important" consideration in investment decisions. Survey of 65 investors and 136 executives, The Importance of Corporate Responsibility," Economist Intelligence Unit/Oracle, Feb. 10, 2005

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